RETAINAGE ON GOVERNMENT CONSTRUCTION CONTRACTS

HEARING

BEFORE THE

SUBCOMMITTEE ON FEDERAL EXPENDITURES, RESEARCH, AND RULES

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

S. 1782

TO AMEND SECTION 305 OF THE FEDERAL PROPERTY AND ADMINISTRATIVE SERVICES ACT OF 1949 PERTAINING TO CONTRACT PROGRESS PAYMENTS MADE BY AGENCIES OF THE FEDERAL GOVERNMENT, PROVIDING FOR THE ELIMINATION OF RETAINAGE IN CERTAIN INSTANCES, AND FOR OTHER PURPOSES

AUGUST 18, 1982

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RETAINAGE ON GOVERNMENT CONSTRUCTION CONTRACTS

WEDNESDAY, AUGUST 18, 1982

U.S. SENATE,
SUBCOMMITTEE ON FEDERAL EXPENDITURES,
RESEARCH, AND RULES,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 3302, Dirksen Senate Office Building, Hon. John C. Danforth (chairman of the subcommittee) presiding.

Present: Senators Durenberger, Chiles, Mattingly, and Nunn.

Staff present: B. Reid Detchon, staff director; William B. Montalto, procurement policy counsel; Robert E. Coakley, minority professional staff member; Robert F. Harris, minority deputy staff director; Patricia A. Otto, chief clerk; Jeffrey A. Minsky, chief investigator, Subcommittee on Oversight of Government Management; Karah Henry, staff director, Subcommittee on Congressional Operations and Oversight; Tonja Musko, staff counsel, Subcommittee on Civil Service, Post Office, and General Services; and Stephen Lowe, legislative assistant to Senator Durenberger.

OPENING STATEMENT OF SENATOR DANFORTH

Senator **DANFORTH**. The subcommittee convenes today to receive testimony on the Government's current practices with regard to retainage on procurement contracts, especially construction contracts. Specifically, we will be considering S. 1782, the Small Business Contract Payment Procedures Act, introduced by Senator Lowell Weicker.

The Government currently withholds—or retains—a percentage of the "progress payments" due to a contractor at various stages in the performance of the contract. The amount retained varies, but is generally 10 percent or less of each progress payment. Proponents of this practice say it insures that the contractor will complete the job on time and in full conformity with the specifications and other terms of the contract. They also note that retainage is a longstanding practice in the construction industry. And, since the amount retained has traditionally approximated the contractor's anticipated profit on the job, the financial impact has been minimal.

But Government construction contractors already are required to post a performance bond equal to 100 percent of the contract price. The surety bond company guarantees to the Government that the job will be completed if the contractor defaults. The cost of this protection is passed along to the Government in the contractor's bid price and amounts to 1 to 2 percent of the contract price.

Today, many contractors—especially small contractors—are operating at profit margins well below a retainage level of 10 percent. When work is scarce and competition is fierce, even a 5-percent retainage may put a contractor into a negative cash flow situation. To meet payrolls, to pay suppliers, to keep the doors open, many contractors—especially small contractors—must borrow. At today's high interest rates, the cost of borrowing—to cover anticipated retainage—can further erode or even eliminate the contractor's small profit margin. Alternatively, the Government may end up paying the cost of borrowing in the contractor's bid price, in addition to the cost of the performance bond. To make matters still worse, the contractor's short-term borrowing often must be extended to cover delays of 6 to 12 months before the Government releases the amounts retained. This is unacceptable.

In this connection, I believe that an aggressive application of the Prompt Payment Act, which I sponsored along with Senators Weicker and Chiles, could solve this delayed payout problem. The act goes into effect on October 1 of this year and applies to progress payments due to contractors. Unless the contract provides otherwise, a contractor would be entitled to receive the amount retained by the Government within 30 days after invoice and acceptance of the job.

The effects of retainage on contractors seem clear. Today we will be asking whether S. 1782 is the answer.

The administration says it is not. It argues for a regulatory solution. But will we see one? Will an improved government-wide retainage policy be included in the forthcoming Federal Acquisition Regulations? Will the Office of Federal Procurement Policy issue a policy letter providing relief?

I believe that Senator Weicker's bill points us in the right direction. S. 1782 calls for the Government contracting officer to exercise judgment, not merely deduct the retainage prescribed by regulation. The bill authorizes the contracting officer to pay the contractor the full progress payment that is due, upon a finding of satisfactory performance.

The contracting officer already must determine that the contractor's performance warrants a progress payment. Why can't the contracting officer make a further judgment that the progress payment can be made in full?

Why should an automatic 10 percent be retained if the contracting officer determines that 3 percent would protect the Government adequately? The Department of Defense has found that a flexible system managed by the contracting officer can provide adequate protection to the Government.

On February 26, the administration sent us its Proposal for a Uniform Federal Procurement System. Those reforms emphasize increased flexibility in the procurement system—increased reliance on the professional judgment of the contracting officer, especially in monitoring contract performance. Yet the administration seems unwilling to adhere to those principles in this context.

Our first witness today is the sponsor of this bill. Senator Weicker, we are pleased to have you with us.

TESTIMONY OF HON. LOWELL P. WEICKER, JR., U.S. SENATOR FROM THE STATE OF CONNECTICUT, ACCOMPANIED BY KIMBERLY A. ELLIOTT, PROFESSIONAL STAFF MEMBER, SENATE COMMITTEE ON SMALL BUSINESS

Senator **Weicker**. It is nice to be with you, Mr. Chairman.

I am pleased to appear before this subcommittee today to testify in support of S. 1782, the Small Business Contract Payment Procedures Act. This bill, which I introduced last October, would eliminate the practice of retainage on Federal construction contracts if certain conditions are met.

Very simply, Mr. Chairman, retainage is a practice whereby Government agencies withhold 10 percent of a contractor's payments until the project is completed. As a Federal procurement regulation, it is practiced by most of the civilian agencies of the Federal Government. The Department of Defense, to its credit, has eliminated the use of retainage in most cases.

At one time retainage no doubt made sense, but it does not make sense any more.

An industry survey estimates that some $2½ billion in retainage payments sit idle in Federal coffers each year. This is money that could be meeting payrolls, paying operating expenses, or being invested in plant expansion or new equipment.

I know I do not need to tell any of the Members here today that the construction industry is going through some rough times right now. High interest rates, a dwindling consumer market, and a decreasing availability of capital have thrown a number of firms into bankruptcy and are severely squeezing many others.

In times like these, every dollar counts. It does not do any of us any good—not the contractor, the Government, or the taxpayer—to have tens of thousands of those dollars tied up because of a retainage requirement which is frankly archaic and unnecessary.

There is no question in my mind that the chairman's bill relative to late payments, the 1-percent tax reduction in the lowest two brackets for 2 years enacted in the Tax Reform Act of 1981, and this type of measure all together could give a great deal of additional capital to firms which are involved in this process.

I know that we, here in Washington, are quite used to dealing in billions of dollars, but in business thousands of dollars make the difference between standing up or going belly up. Right now the statistics are just awesome concerning the number of small businesses—as most of these firms are—that are going belly up in the country today.

Let me make a couple of points.

First, retainage was designed to insure that Federal construction contracts are completed satisfactorily. That is fine, but in the years since it was put on the books, a new regulation requiring Federal contractors to post performance bonds on all jobs to guarantee completion was created. Clearly, with the performance bond as a guarantee, we do not also need retainage.

Second, retainage is actually costing the Government money. According to a recent industry survey, contractors currently add on an average of 3.7 percent to their bids when retainage is required. In other words, to recoup the costs incurred when they have to borrow money to cover outstanding retainage payments and maintain adequate cash flow, contractors add these costs into the total price of the bid.

With the elimination of retainage, I am confident we could stop this artificial inflation of Government contracts and actually save the Government money. Additionally, once retainage is lifted, I believe you will see a substantial increase in the numbers of firms bidding on Federal contracts. This increased competition will surely result in an overall lowering of bid prices for Federal contracts.

Finally, Mr. Chairman, I would note that retainage is intended as an incentive for firms to complete their work in a timely and speedy fashion. In fact, it appears the opposite is true. With construction now being completed by many different subcontractors, the firms that complete the bulk of the work before the whole project is done have absolutely no incentive to finish up the final details quickly because retainages are not released until the owner accepts the whole finished building. So, rather than hurrying to complete a job and then waiting months for payment, these contractors commit their resources to current projects where full payment can be expected and take their time on the Federal job.

I think, Mr. Chairman, it is important to note that my bill does not do away with retainage entirely. Under the legislation, agencies can still impose retainage requirements should a project proceed unsatisfactorily. The bill simply says that unless the work being done by any Federal contractor is unsatisfactory or behind schedule retainage should be waived. Similarly, for small businesses, it would prohibit retainage when an adequate performance bond has been posted.

I find it ironic, Mr. Chairman, that the Office of Management and Budget opposes this bill since as I believe it goes to the very heart of supply-side economics. If indeed our plans for economic recovery hinge on spurring capital investment and increased expansion and production by this Nation's businesses, then it seems to me intensely counterproductive to continue a practice which ties up billions of dollars each year which could be used to this end.

I hope, Mr. Chairman, as it did with the late payments legislation, your subcommittee will act favorably on S. 1782.

Thank you.

Senator DANFORTH. Thank you very much, Senator Weicker.

As I understand it, the administration takes the position that this problem can be solved through regulation and does not require a statute. What is your response to that?

Senator WEICKER. I doubt that this contention is true since we are operating under regulations now. Regulations are precisely what I am trying to get rid of in favor of some commonsense and judgment on a case-by-case basis.

Senator DANFORTH. You believe that this is a matter to which Congress should direct its attention and that if the administration were going to solve the problem by regulation it would have done so before now.

Senator WEICKER. I think so.

I repeat, what we are trying to do is to show a little ingenuity in finding capital without cost to the taxpayers. Here is an example of just that.

I realize, as does the chairman, that to stop the Government entirely from regulating would be equally as wrong. I am trying to take the middle ground.

I am sorry that someone has to do some thinking in the agencies on a case-by-case basis. It would be nice to have the old regs in front of the contracting officers so that they could decide on that basis, but I believe that the human mind is better than anything etched into stone.

Senator DANFORTH. This bill pertains to retainage between the Government and the general contractor. What is your view with respect to any sort of passthrough arrangement to the subcontractors?

Senator WEICKER. I believe that the Government should only be responsible for the relationship that exists between the Government and an individual or an entity. I do not want to get into the process farther down the line.

I have prepared a formal response to this question for the record. S. 1782 covers direct contracts with the Government. Subcontractors generally do not have a direct contracting relationship with the Government, rather contract directly with the prime contractor.

I believe it is one thing for the Congress to legislate how the Government does business with its prime contractors but quite another matter for the Congress to dictate payment practices between private parties.

I gather that general contractors occasionally do pass through certain social and accounting requirements to their subcontractors, but I feel that these contract clauses were carefully reviewed by Congress in light of social and other goals. I do not consider that this is the case with retainage practices.

I believe that contracting officers, in S. 1782, can provide prime contractors with the flexibility to withhold retainages in certain instances when a subcontractor's work is not being performed in a timely or satisfactory manner.

Senator DANFORTH. You would oppose amending the bill to cover subcontractors?

Senator WEICKER. I think it raises another point. I think it does get the Government into the position of being a potential referee between contractors and subcontractors. I am not sure that we are equipped to do that.

Senator DANFORTH. Thank you very much, Senator Weicker. You are welcome to join me if you wish.

Senator WEICKER. Thank you very much, Mr. Chairman. I have a little problem brewing on the floor. I think I had better go over and deal with that.

Senator DANFORTH. The next witnesses are William Forder, Kenneth Krauska, and Arthur Meushaw.

Senator Durenberger.

OPENING STATEMENT OF SENATOR DURENBERGER

Senator **Durenberger**. Good morning, Mr. Chairman.

I will join you. Before I do, I want to introduce one member of this panel, because way back when I was exploring the possibility of running for public office, he was one of the small business persons who had decided that they could not just run their small businesses for 16 hours per day and complain about Government. Somehow or another they had to get involved. That is how I met Bill Forder from St. Paul.

He has stayed involved in the process, as he will indicate today, in a policy sense. He and his wife Barbara are very involved, not only in the business which they founded back in 1966 but in how the business relates to the community and how all of that relates to Government.

Bill is the president of a company called Faircon, Inc. It is located in St. Paul, Minn. It is a mechanical and roofing contracting firm. As I indicated, he founded the firm in 1966. He represents today an organization with which you are undoubtedly familiar; namely, the Sheet Metal and Air Conditioning Contractors' National Association, Inc.

I commend to you, the rest of the subcommittee, and to all of those who will read the report of today's hearing his testimony on the issue which Senator Weicker, I, and others are cosponsoring.

Senator **Danforth**. Thank you, Senator Durenberger.

Would you like to proceed, Mr. Forder?

TESTIMONY OF WILLIAM R. FORDER, PRESIDENT, FAIRCON, INC., ON BEHALF OF THE SHEET METAL AND AIR CONDITIONING CONTRACTORS' NATIONAL ASSOCIATION, INC.

Mr. **Forder**. Good morning, Mr. Chairman and members of the subcommittee. My name is William R. Forder. I am president of Faircon, Inc., located in St. Paul, Minn. Faircon, Inc., is a mechanical and roofing contracting firm which I founded in 1966, as you have just heard. Our work includes fabrication and installation of heating, ventilating, and air-conditioning systems for commercial and industrial buildings.

I am also a member of SMACNA, the Sheet Metal and Air Conditioning Contractors' National Association, Inc., which represents some 2,700 sheet metal contractors involved in various applications of the sheet metal trade.

I thank you and the members of this subcommittee for inviting me to come here today to testify on S. 1782, the Small Business Contract Payment Procedures Act. If passed, this bill would eliminate the practice of retainage on Federal projects, provided certain qualifications are met by the contractor.

This morning I will go through a theoretical job to show the effects of retainage on cost and cash flow. Before I do that, let me explain what it is that I hope to demonstrate by my brief testimony here this morning.

First, retainage inflates the cost of contracts. Second, cash flow problems caused by retainage can be devastating to contractors, particularly small contractors. Third, elimination of retainage should be extended to the private as well as the public sector.

Fourth, legislation to eliminate retainage should include a flow-down provision to address retention of payment between prime contractors and subcontractors.

In connection with the theoretical job I will describe to you in a moment, I have prepared two exhibits which show the flow of cash and costs for this project with and without retainage. Exhibit 1 shows the job without retainage. Exhibit 2 shows the same job and the effect of retainage.

This theoretical job assumes conditions are ideal and all retainage is paid 30 days after the final billing. In reviewing actual jobs of this size, the final retainage payment is usually held from 6 to 12 months. In fact, I could not find a job from our shop where retainage was paid in less than 3 months.

Here are the parameters of this theoretical job: The size of the contract is $275,000. Its duration is 12 months. The net profit of 5 percent is $13,750. Industry studies show that actual profits usually range between 2 to 5 percent before taxes. Costs are $275,000 minus $13,750, or $261,250. Material costs of 50 percent of the contract are $130,625, and material payments equal $10,885 per month. Labor is 50 percent, or $130,625, and equals $10,885 per month. Invoices at the end of the month are $22,917 per month. Payments are received in 30 days, and interest on any borrowed money is at 18 percent. The two exhibits are based on the theoretical job.

The exhibits show several things: The shaded area reflects the amount of dollars that I would have to borrow from month to month on this job in order to make all of the necessary payments for labor and materials.

In this example, the average amount I must borrow with retainage is $25,908 and without retainage, $14,272. The maximum amount borrowed with retainage would be $44,105 and without retainage, $32,655.

At months 2 and 12 of the project, expenses are $32,655 with or without retainage and $250,365 with or without retainage, respectively. Borrowing at month 2 is $32,655 with or without retainage, but at month 12, $44,105 with retainage and $21,195 without retainage.

These figures show that even under ideal conditions there are major cost consequences. Cash flow is a major problem to the contractor. In today's market it could be the straw that breaks the camel's back. The cost of retainage is passed on to the consumer, in this case the taxpayer. The 0.8 percent of sales is more likely to be 1.5 percent to 2 percent or more. This may not sound significant, but when we are talking about billions of dollars in sales, we are talking about millions of dollars in savings.

This legislation is a step in the right direction but falls short in two very critical areas: One, it applies only to public contracts, and two, there is no provision to require a flow-down or retainage payments between prime contractors and subcontractors.

I understand that some individuals have argued that Congress does not have the authority to legislate the issue of flow-down because the Federal Government is not in a "privity of contract" relationship with the subcontractor. However, based on the information and legal advice I have received from my national association, I believe that any such arguments are flawed in several respects. Rather than go into a full legal explanation today, I have attached for the record a memorandum from our attorneys outlining the legal justifications and language that would allow Congress to include a flow-down provision in the legislation. Our association will be happy to work with you on language that would accomplish that goal.

In conclusion, Mr. Chairman, let me summarize the four key points in my testimony with regard to S. 1782. One, retainage inflates the cost of contracts; two, cash flow problems caused by retainage can be devastating to contractors, particularly small contractors; three, elimination of retainage should be extended to the private as well as public sectors; four, legislation to eliminate retainage should include a flow-down provision to address retention of payment between prime contractors and subcontractors.

Finally, Mr. Chairman, I thank you and the members of this subcommittee for inviting me to testify before you here today. I applaud your efforts to bring this often overlooked situation to the attention of your colleagues in the Senate. I hope we can work together to solve this problem.

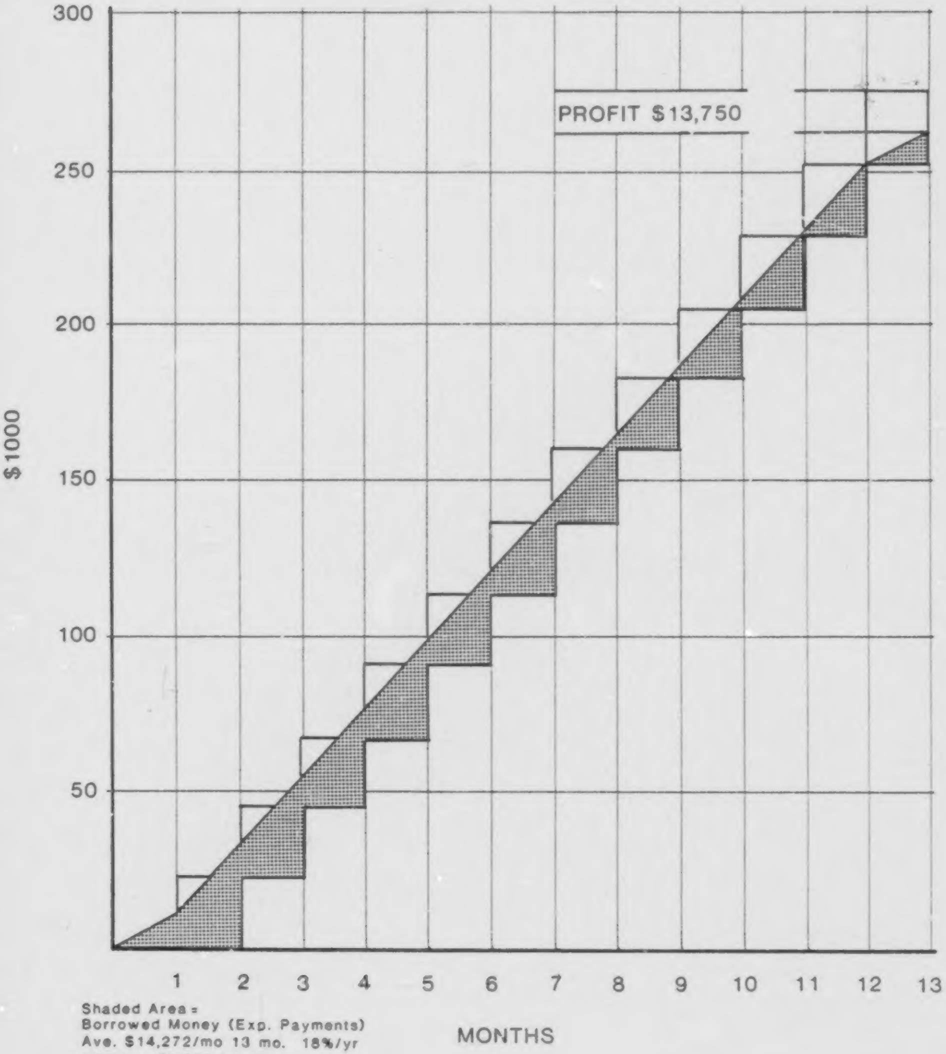
I would be pleased to answer any questions you may have at this time.

Senator **Danforth**. Thank you, Mr. Forder. Without objection, the attachments to your statement will be made a part of the record at this point.

[Attachments to Mr. Forder's statement follow:]

EXHIBIT #1 NO RETAINAGE

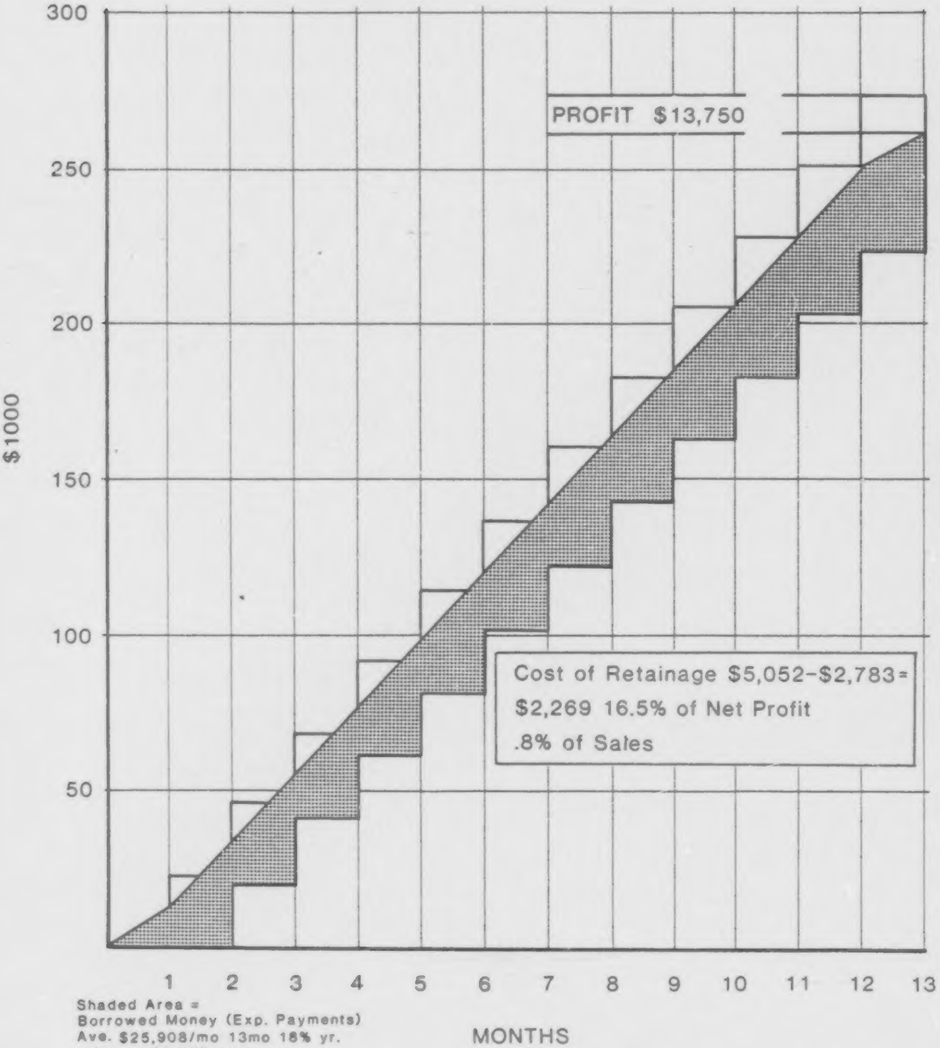
☐Job Value	$275,000
☐Estimated Labor	$130,625
☐Materials	$130,625
☐Estimated Net Profit 5%	$13,750
Labor Cost/mo	$10,885
Materials Cost/mo	$10,885
Maximum Borrowed	$32,655



Shaded Area =
Borrowed Money (Exp. Payments)
Ave. $14,272/mo 13 mo. 18%/yr
1.5%/mo $2,783 Interest

EXHIBIT #2 RETAINAGE

☐ Job Value	$275,000
☐ Estimated Labor	$130,625
☐ Materials	$130,625
☐ Estimated Net Profit 5%	$13,750
Labor Cost/mo	$10,885
Materials Cost/mo	$10,885
Maximum Borrowed	$44,105



Shaded Area =
Borrowed Money (Exp. Payments)
Ave. $25,908/mo 13mo 18% yr.
1.5%/mo $5,052 Interest

MEMORANDUM

RE: Small Business Contract
Payment Procedures Act

Two bills - H.R. 5022 and S. 1782 - have recently been introduced in Congress concerning retention of progress payments on contracts between the federal government and its contractors. This legislation does not address retention of payments between contractors and subcontractors. Some individuals have argued, however, that Congress does not have the authority to legislate regarding this issue, because the federal government is not in privity of contract with subcontractors. This argument is flawed in several respects.

The only limitation on congressional power to legislate are those contained in the Constitution. Those individuals who argue that lack of privity deprives Congress of its authority to legislate, are really saying that the Constitution requires privity of contract for Congress to legislate.

First, even if privity of contract were constitutionally required, Congress would have the authority to legislate regarding retention of payments between contractors and subcontractors. Federal contractors are in privity of contract with the federal government. To regulate retention between contractors and subcontractors it is only necessary to regulate the contractors. Congress could enact legislation requiring contractors, as a condition of doing business with the federal government, to comply with certain laws and regulations regarding retention of payments to their subcontractors. This legislation would apply only to contractors who are in privity with the federal government, but it would effectively regulate contract retention between contractors and subcontractors.

Second, privity of contract is not constitutionally required. The Constitution does not -- either directly or indirectly -- make privity of contract a prerequisite for assertion of congressional authority. Congress has enacted thousands of laws regulating millions of individuals and businesses, the vast majority of whom are not in privity with the federal government. To give just a few examples, Congress has enacted the federal income tax, the Fair Labor Standards Act, which requires businesses to pay their employees the federal minimum wage; the National Labor Relations Act which regulates labor relations between employers and labor organizations; and the Davis-Bacon Act, which specifically provides that contractors and subcontractors performing construction work for the federal government have to pay their employees certain minimum wages. All of these laws apply with equal force to subcontractors who are not in privity with the federal government. Subcontractors pay federal income taxes, subcontractors are subject to the Fair Labor Standards Act; subcontractors are subject to the National Labor Relations Act; and subcontractors are explicitly subject to the Davis-Bacon Act. Lack of privity does not deprive Congress of its authority to legislate.

Beyond the question of privity, the Constitution does not restrict congressional authority to enact legislation regarding retention of payments between contractors and subcontractors. One could argue that such legislation would violate the Fifth Amendment, because it would deprive contractors and subcontractors of liberty and property "without due process of law." However, the Supreme Court has consistently held that when a legislature passes a law which affects a general class of persons - in this case, contractors and subcontractors - those persons have all received due process - the legislative process. Nowak, Rotunda, & Young, Constitutional Law, p. 500 (1978) (hereinafter cited as "Nowak"). See, for example, Bi-Metallic Investment Co. v. Colorado, 239 U.S. 441 (1915). In addition, one could argue that such legislation would impair the obligation of contracts between contractors and subcontractors, and hence would violate the Due Process Clause of the Fifth Amendment. This argument could be made only if the legislation applied to current contracts. Most likely the legislation would apply only to future contracts. However, even if it did apply to current contracts, the Supreme

Court has displayed a willingness to uphold federal legislation impairing obligation of contracts so long as the legislation has a "rational relationship to a proper governmental end . . . even though it may impair recognizable property rights." Nowak, p. 433. Since insuring a stable construction industry is certainly a "proper governmental end," impairment of contract is not a justifiable constitutional objection to such legislation. Finally, one could argue that such legislation exceeds Congressional power under the Commerce Clause, because it regulates payment retention and not commerce. In response to that argument it should be recognized that since 1936 the Supreme Court has not invalidated any federal law requiring private parties because it exceeded the commerce power. See Tribe, American Constitutional Law, pp. 235-36. In short, the Constitution does not deprive Congress of its authority to legislate regarding payment retention between contractors and subcontractors.

In summary, Congress has full authority to regulate retention of progress payments between federal contractors and their subcontractors for these reasons:

1. Even if privity of contract were constitutionally required, the federal government could require contractors - who are in privity with the federal government - to comply with laws and regulations regarding retention of payments to their subcontractors.
2. Privity of contract is not constitutionally required.
3. Beyond the question of privity, there is no other justifiable basis for an assertion that legislation regarding retention of payments between contractors and subcontractors is beyond congressional authority.

FELHABER, LARSON, FENLON & VOGT, P.A.

Robert J. Fenlon

PROPOSED AMENDMENT TO S. 1782 AND H.R. 5022

"(e) Executive agencies shall require -

"(1) All parties receiving payments pursuant to subsections (d)(2) and (d)(3) to immediately pay their subcontractors in full without retention of any percentages of the contract price for all work performed by the subcontractors; and

"(2) All subcontractors receiving payments pursuant to subsection (e)(1) of this subsection to pay their subcontractors, if any, in full without retention of any percentage of the contract price for all work performed by the subcontractors."

Senator **Danforth**. Mr. Krauska.

TESTIMONY OF KENNETH E. KRAUSKA, PRESIDENT, PLUMBING ENGINEERS & DESIGN INC.; ON BEHALF OF THE NATIONAL ASSOCIATION OF PLUMBING-HEATING-COOLING CONTRACTORS

Mr. **Krauska**. Thank you, Mr. Chairman. My name is Kenneth E. Krauska. I am the owner of Plumbing Engineers & Design Inc. My corporation is primarily active in commercial construction and federally funded housing projects in St. Louis. I have been in business for 5½ years and in that span of time have completed four section 8 HUD projects. We are also, at this time, finalizing a remodeling of the original U.S. customshouse in downtown St. Louis.

I am here today, not only to represent my firm, Plumbing Engineers & Design, but also the Plumbing Contractors Association of Metropolitan St. Louis, of which I am currently president, and the National Association of Plumbing-Heating-Cooling Contractors, of which I am a member.

Our associations are definitely in favor of the elimination of retainage on Federal projects. Because of the experience of the 102 members of the St. Louis organization and myself, I have listed below a few of the reasons why we are so adamantly in favor of this bill's passage.

The first item to discuss is the procedure for the release of monthly pay requests. The reason for this is not only to disclose the tremendous amount of redtape involved with each request, but it is also the final step in obtaining our retainage, after waiting sometimes as long as 12 months. This process can and should be reduced.

Our monthly pay request starts off with a subcontractor submitting his bill to the general contractor. The general contractor in turn submits it to HUD. HUD submits it to the architect, the architect to the owner, the owner to the title company, the title company back to HUD, HUD to the architectural division of HUD, the architectural division to mortgage credit, mortgage credit to the HUD regional office in Kansas City, Kansas City to the Denver Treasury, Denver to the bank, the bank to the title company, the title company to the general contractor, and finally to us. There are 14 steps. At 2 days per step, that is 28 working days. There is no way possible for us to get the money in 30 days on our monthly billings or after the retainage's release is approved.

Not only is it imperative to streamline this unnecessary bureaucratic nonsense, but after waiting for the monthly draw, having 10 percent held monthly in retainage and then having to wait for what sometimes seems like an eternity, it is clearly necessary to eliminate this unwarranted restriction on small businessmen.

Listed below are the projects which my firm has completed and the dates of final retainage release when applicable.

We did a project called Santa Maria Apartments. The substantial completion date was January 29, 1979. The date when the retention was received was November 18, 1979. That was 10 months later.

We did the Bevo Place Apartments. Substantial completion was on July 10, 1980. The date when the retainage was paid was August 24, 1981.

We did Metropolitan Village. Substantial completion was on February 10, 1982. Retainage due me on that project—retainage to the subcontractors having already been paid by me—is still due me in the amount of $18,000. There is no answer as to when the retainage is coming.

We did the AHEPA-53 Apartments. Substantial completion was on April 30, 1982. I have $24,000 due on that project. All bills have been paid. All subcontractors retainages have been released, and I do not know when I will receive the money.

We are doing the U.S. customshouse. Substantial completion was on June 9, 1982. There is no word from GSA as to when the money will be forthcoming.

These projects had people occupying the buildings before or at the time of substantial completion. All invoices were paid. Payrolls were met. Overhead was accounted for. You can see that the only ones to be financially suppressed were the contractors who paid the bills and performed the work. They had 10 percent of their contracts withheld.

I believe another important aspect which has to be addressed is that all subcontractors bid projects. If they are the successful low bidders, they are contractually obligated to a price. The general contractor agrees that his proposal, which includes all subcontractors, is in essence on a time and materials basis, not to exceed the original base bid.

This requirement theoretically justifies HUD's provision of a cost certification prior to the retainage release. If subcontractors are contractually obligated to their bid documents, then I believe that we should be paid the retainage upon the finalization of the punch list and the effective date of substantial completion. There is no reason to hold 5 or 10 percent of an entire project amount because of the final cost evaluations by the general contractor, which include wage review, certified payrolls, and cost certifications.

Additional problems could also arise due to the developer's possible overrun on construction costs. He, in turn, does not have to pay the interest until final closing, or he might have cheaper construction financing in lieu of his upcoming permanent financing. It would be to his benefit to delay the closing as long as possible.

The Federal Government's mountain of redtape is further multiplied by requiring the general contractor to cost-certify the project when the developer and finally the HUD office has to do the same before the retention can be distributed for payment.

Small businessmen cannot afford to continue to deal with the vast accumulation of governmental procedures that remain unhampered by constructive criticism. Retainage is the single worst deterrent to the construction field, and the passage of S. 1782 is imperative to our industry. To eliminate retainage will reflect a more competitive price and thereby help our sagging industry.

Thank you for the opportunity to express my views. I am anxious to answer your questions.

Senator **Danforth**. Thank you, sir. Without objection, your prepared statement will be inserted in the record following the testimony of this panel.

Mr. Meushaw.

TESTIMONY OF ARTHUR C. MEUSHAW, PRESIDENT, STANDARD ACOUSTICS, ON BEHALF OF THE AMERICAN SUBCONTRACTORS ASSOCIATION

Mr. **Meushaw**. I am Arthur Meushaw. I actually have two hats on. I am president of Standard Acoustics, which is an interior finish contractor. That is a fancy way of saying that we build interiors in Washington, D.C. My company is some 48 years old. I have been there for 32 of those years as president of the company. My other hat is as vice president of the American Subcontractors Association [ASA]. We have a number of advisory council associations.

Since time is limited, I will move on. We filed a statement with the committee. My observations are taken from the statement.

ASA believes that over 80 percent of a typical office building—for example, a Pentagon—is subcontracted. Today we believe that, in many cases, the general contractor is a broker.

Conversely, the same subcontractor often works as a prime contractor. Do not think that, when I speak of being a subcontractor, we only do that. As a matter of fact, every day in Washington, D.C., the Federal Government is giving work to what we would call a subcontractor or a specialty contractor.

As has been said by my colleagues and Senator Weicker, the industry is made up of a lot of small companies. It is a very, very competitive industry. Due to its highly competitive nature, where brother fights brother daily, versus something like the medical profession, the firms are held together as if by a rope of sand.

It is the only business with retainage. With auto, TV, or other personal property, one relies upon warranties from the manufacturer or the dealer. But what does the Government do? What is its normal practice? It is a performance bond and retainage. It is also the normal written contractual remedies, such as if the bonding company takes over one and subrogates it.

One of the things we would like to stress is this. We have been to all of the various executive departments. In most cases, their retainage practices vary. For instance, Interior, a month or 2 months ago, had a 4-percent average across the board. Yesterday, at our firm, we took a look at a request for bid from Fish and Wildlife. It is 10 percent to the end. DOD, as of February, is zero. The Veterans Administration is 10-percent retainage to 50-percent completion. The U.S. Postal Service is 10 to 50, and so on.

Retainage is a cancer. It strangles a contractor, as has been pointed out before. I do not think anyone knows how much money is involved, but it has been estimated to be over the billion dollar mark. It adds to unfair business practices. It promotes increased costs. It gives one credit problems. It leads to bankruptcy.

You may ask why we have retainage. The best answer I have ever been able to think of is that it is historical. Time does not allow me to go into that.

I might add that it is interesting to note that AGC in its published retention policy calls for 5 percent on any project except for building projects where it recommends 10 percent. The interesting point is that on all projects where they are not using subcontractors but they are using direct, such as in their road work where they are using very few subcontractors, they only want 5 percent.

I could go on and on about what it means to us. I am sure all of the other witnesses will mention cash flow.

I will go on to something which is local. The Washington ASA chapter has 365 firms, all working for the Government and all complaining about retainage. It makes it hard for them to get themselves going and keep moving.

Incidentally, the trend is toward less retainage. Recently, Virginia went from 10 to 5 percent. I think that was 2 years ago.

Time is up, although I could go on. I just hope that S. 1782 is passed. Thank you.

Senator DANFORTH. Thank you very much, Mr. Meushaw. Without objection, your prepared statement will be included in the record.

Let me ask you this. Would this bill be of help to you without a flow-down provision?

Mr. MEUSHAW. Yes.

Senator DANFORTH. How?

Mr. MEUSHAW. I prefer a flow-down provision.

Senator DANFORTH. How would it be helpful?

Mr. MEUSHAW. Do you mean in acting as a subcontractor? All general contractors are not bad guys. Therefore, if a general contractor has a flow-down, I think that the great majority of them will live with it and will pass it on.

Senator DANFORTH. Do you think that we have to provide a flow-down in the bill itself, or would the prime contractor provide it as a matter of course?

Mr. MEUSHAW. As a practical matter, I would like to see the flow-down, but it may not be practical. We may not be able to get it. As I said before, retainage in the construction industry is so unfair. We will take a bone.

Senator DANFORTH. Would you like to answer, Mr. Forder?

Mr. FORDER. I would have to agree that we would certainly like a flow-down provision. I think that a good share of the subcontractors I have talked to feel that it is necessary. It goes back to who it is you are dealing with in a lot of cases. A good general contractor can live with it. I think there are a lot of cases where it would be difficult to do without it.

Senator DANFORTH. Is most of the business you do with the Government as a subcontractor?

Mr. FORDER. Yes.

Senator DANFORTH. Is that almost all of the work you do?

Mr. FORDER. Yes.

Senator DANFORTH. If there were no flow-down provision in the bill, you would in effect be relying on the prime contractor to pass it on voluntarily, is that right?

Mr. FORDER. Yes, we would be relying on the integrity of the prime contractor, who would like to keep the cash himself.

Senator **Danforth**. What would be your guess as to whether or not the general contractors would pass it on if there were no flow-down provision? Would flow-down be the general rule, or would it be the exception?

Mr. **Forder**. I can only speak for myself. I guess I am somewhat selective in the general contractors with whom I work. I do not believe it is as big a problem for me as it would be for a lot of the other subcontractors with whom I have talked, but it is a definite problem.

Senator **Danforth**. Would you think it would be more likely than not that the improved practices being proposed would not be passed on?

Mr. **Forder**. That is what I have been hearing.

Senator **Danforth**. What is your opinion, Mr. Krauska?

Mr. **Krauska**. I fully agree. I think, without a flow-down provision, the general contractors will not pass it on to the subs.

Senator **Danforth**. How would a flow-down provision function? It is my understanding of this bill that it does not require the Government to forgo retainage. It simply authorizes flexibility. It says that the Government may or may not fully exercise the contract's retainage provision. The amount of the retainage could vary.

Suppose that the general contractor had some subs whom he felt were more reliable than others. Would he exercise the same flexibility, or would you find that the general contractor would take the same retainage as he has with the Government?

Mr. **Forder**. I do not think that we are talking about the same things here. With retainage, you are talking about moneys you have coming to you. Assuming that the subcontractor has done the job adequately and assuming that he has the proper billing in, it is agreed that he is owed this money, and they are retaining ten percent of this money. If the contractor is not doing his job, or if he has some problems, he will not get paid anyway. If he overbills, he will not get paid. I think it is a separate issue. If the general contractor has reason not to pay the sub, he should not pay him, but we are only talking about money which everyone agrees that the subcontractor has coming to him. I think that is the inequity of withholding 10 percent of money which everyone agrees he has coming.

Senator **Danforth**. Isn't the concept of retainage the same whether it operates between the Government and the prime contractor or between the prime contractor to the sub? Isn't the concept just the same?

Mr. **Forder**. You are still relying on the integrity of some person to pay the bills you have coming. I am not sure that I follow what you mean.

Senator **Danforth**. There was at least some basis for the concept of retainage. There is still some argument for its use. Maybe it does not work very well, but there is an argument that the purpose of retainage is to assure that a contract will be completed as agreed to and that all of the details will be wrapped up.

If that is a correct assumption with respect to the relationship between the Government and the prime contractor, doesn't the same concept apply with respect to the relationship between the general contractor and the sub?

Mr. **Forder**. The same concept applies. I disagree with the concept to start with.

First of all, the subs are always accused of overbilling. I think they are kidding themselves. By the time you pay your labor for 30 days and the overhead has gone on for many days before the contract is even started, I really do not think that there is front-end loading or overbilling. I think that generally you are underbilled. I think, if there is proper inspection of the job, it will not be overpaid.

Mr. **Krauska**. Supposedly, the reason for the retainage is to guarantee that jobs will be completed. The jobs are bonded. That is the guarantee.

The retainages which are being held are old retainages. Ten percent is ridiculous because the majority of contracts now are 10 percent until 50 percent completion of the project; then they reduce it to 5. Then, upon completion of the project, it is 30 days for release of the retainage. We are sometimes talking about an overall drag of 14 months. That is the big one.

Senator **Danforth**. Mr. Meushaw, would you like to add anything?

Mr. **Meushaw**. No.

Senator **Danforth**. Senator Durenberger.

Senator **Durenberger**. I only have a question or two which follow the theory of retention.

I assumed that it went beyond history or AGC guidelines. I am curious to know whether it is possible in advance to contract for adequate performance, using a retainage of some kind, but requiring the contractor, or the Government in this case, to pay some kind of a price for using retainage at some percentage. The price might be in the form of an interest rate of some kind or a penalty or something, which can be effected after some period of time.

Will each of you comment on the possibility of there being some little value to retainage as long as everyone contracts for it in the beginning but puts a price on utilization of retainage by the contractor?

Mr. **Forder**. It would be better than nothing, but it would not be acceptable in my opinion. It does not solve the cash flow problem. For a contractor, especially a small contractor, this is really a problem. We then become a banker. Someone else has our money. There is no incentive to pay the money. They are using the money to operate, even if they are paying interest on it.

In our own business, as one example, we borrow money for operating capital, not for large expenses but for cash flow purposes. We have never borrowed more than $100,000 at any one time. I looked over our retention last year. Our retention averaged approximately $100,000 a month. We have never borrowed over $100,000 under the worst conditions over the last year, which is the most we have ever borrowed for working capital. If we did not have retainage, we would not be borrowing any money today.

Senator **Durenberger**. I do not know whether anyone else wants to comment on that, but I was also thinking that the good side of it is that if I am the contractor I may have some cash flow problems, too. I know there are performance bonds and various things which you have to go through in order to effectuate the bonds, but assume that the sub, or whoever it is with whom I have contracted, does not provide me, by a certain period with a good or service for which I contracted. Obviously, that costs me money which, until I can utilize the bond or some other enforcement procedure, is a cash flow problem for me, especially if it is a building. There is a theoretical flip side to this thing, too. I am just dealing with other pricing mechanisms which might be utilized.

Mr. **KRAUSKA**. Billings have to be on a monthly basis, reviewed by your particular office, and approved. If we are overbilling, then you reject the billing. That does not help anyone at all. You are still holding a retainage as far as the billing is concerned. That is your clout. The fact that you are holding back on the monthly billing if you feel we are overbilling and holding 10 percent on top of that is something else.

Senator **DURENBERGER**. Mr. Meushaw?

Mr. **MEUSHAW**. I think that probably one of the most important points of this bill is the impact it can have on the private sector, although the bill is not aimed at it. That is where 10 percent is a common practice, as I mentioned in my little talk. It is not common practice in the Federal Government. It varies. As you know, DOD is zero. I mentioned some of the other percentages. To add a little sugar, as you mentioned earlier, I don't think would work.

Senator **DURENBERGER**. It might work, but it would not accomplish what we are trying to achieve here; that is, the correction of the cash flow problem.

Mr. **MEUSHAW**. That is right.

Mr. **FORDER**. You still have the same clout. If you are not performing, you will not get paid. If you overbill, you run the risk of not being paid at all on that particular billing. It will be rejected.

We are still talking about the proper billing and everything in order. Everyone agrees that you have the money coming to you, and you hold back 10 percent of the money.

Senator **DURENBERGER**. Thank you.

Thank you, Mr. Chairman, for holding this hearing on the bill.

Senator **DANFORTH**. How important is this bill to you? Would it cure your ills?

Mr. **FORDER**. I guess that there is no one single thing which will correct all ills. I think if we take them one at a time this is definitely an important bill.

Senator **DANFORTH**. Would it be a major help to your business?

Mr. **MEUSHAW**. It would be a tremendous help.

Mr. **KRAUSKA**. Cash flow would be increased.

Senator **DANFORTH**. Thank you all very much.

[The prepared statements of Mr. Krauska and Mr. Meushaw follow:]

PHCC NATIONAL ASSOCIATION OF PLUMBING·HEATING·COOLING CONTRACTORS
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Statement to the

Subcommittee on Federal Expenditures, Research and Rules
of the
Committee on Governmental Affairs
United States Senate

S.1782

Small Business Contract Payment Procedures Act

Presented by:
Mr. Kenneth E. Krauska, President
Plumbing Engineering Design
on behalf of the
National Association of Plumbing-Heating-Cooling Contractors
Plumbing-Heating-Cooling Contractors of Missouri
Plumbing Contractors of Metropolitan St. Louis

August 18, 1982

Mr. Chairman,

My name is Kenneth E. Krauska, and I am the owner of Plumbing Engineers and Design Incorporated. My corporation grosses $1.5 million annually and is primarily active in commercial construction and federally funded housing projects in St. Louis, Missouri. I have been in business for five and one half years and in that span of time have completed four Section 8 HUD Projects.

I am here today to not only represent my firm, but also the 102 members of the Plumbing Contractors Association of Metropolitan St. Louis, of which I am currently President, the Plumbing Heating-Cooling Contractors of Missouri (MAPHCC), the National Association of Plumbing-Heating-Cooling Contractors (NAPHCC), and the Small Business Legislative Council (SBLC). Accompanying me today is Dennis Lavallee, the NAPHCC Director of Government Affairs. Our local, state and national associations are definitely in favor of the elimination of retention on federal projects as expressed in S.1782.

The National Association of Plumbing-Heating-Cooling Contractors is the oldest national association in the construction industry and the largest in the plumbing-heating-cooling industry. It has over 6400 members. Membership comes from every state in the country and is organized through about 300 state and local affiliated associations. This industry employs over 400,000 people and has receipts of over 21 billion dollars.

We are also speaking for the Small Business Legislative Council (SBLC) of which NAPHCC is a member. The SBLC is a coalition of 75 national business and trade associations. Our members represent about 4½ million small business units and cover just about the full range of SIC classifications.

The SB C position paper, (Attachment A), which is attached to this statement, has been approved by the SBLC Executive Committee and is currently pending before our various member organizations as we wait their approvals to be listed in support.

It is important to note that the members of NAPHCC and of SBLC are small businesses and enterprises in the purest sense of the word. Contractors are locally based in the cities and towns throughout the country. Therefore our interests are in our communities and in our states and in our country.

Retainage is Unnecessary Duplicate Regulation

One of the first and foremost reasons for the elimination of retainage is the unnecessary duplicate layer of protection it attempts to provide. In addition to retainage, the contractors are required to put up a performance bond to insure completion of the contract. This is a cost which we pass on in our bid on a contract. It usually runs approximately 1.2 percent of our construction work.

However, despite the performance bond, my company has up to 10% of the payments to which we are entitled held hostage. Meanwhile, we have bought materials, paid for labor and covered for overhead during the construction period. When we complete our contract, we should receive full payment for our work.

However, as a subcontractor, we must continue to wait for payment until the general contractor has received his final payment which enables him to pay us. The result is that withholding retainage severly restricts our cash flow, restricts our ability to compete on other contracts and results in an unnecessary and costly duplicate layer of protection.

Payment Procedures Are Excessibely Burdensome

The second item I want to discuss is the procedure for the release of monthly pay requests which creates further undue burden on us as small business contractors. The reason for this is to disclose the tremendous amount of red tape involved with each request for payment. It is also the procedure which is followed as the final step in obtaining our retention.

Monthly Requisition and Final Retention Release Procedure

1) Subcontractor to General Contractor
2) General Contractor to HUD
3) HUD to the Architect
4) Architect to the Owner
5) Owner to Title Company
6) Title Company to HUD
7) Wage Review at HUD to Architectual Division of HUD
8) Architectual Division of HUD to Mortgage Credit
9) Mortgage Credit to HUD Regional Office in Kansas City
10) Kansas City Office to Denver Treasury
11) Denver Treasury to Bank
12) Bank to the Title Company
13) Title Company to the General Contractor
14) General Contractor to the Subcontractor

After waiting sometimes as long as 13 months, this process can and should be reduced. It is imperative to streamline this unnecessary bureaucratic nonsense. We must wait for the monthly draw. We have ten percent of our monthly payment held in retention. Then we must wait for what seems like an eternity for the retention money. It clearly indicates a necessity to eliminate this unwarranted restriction on small businessmen.

Listed below are the federal projects my firm has recently completed and the dates of final retention release, when applicable.

PROJECTS	SUBSTANTIAL COMPLETION	DATE PAID RETENTION	
Santa Maria	1/29/79	11/18/79	10 Months
Bevo	7/10/80	8/24/81	13 Months
Metropolitan Village	2/10/82	Still Waiting	
AHEPA	4/30/82	Still Waiting	

These projects had people occupying the residences, either before or at the time of substantial completion. All invoices were paid, payrolls met, overhead accounted for. As you can see, the only ones to be financially suppressed are the contractors who paid the bills and performed the work only to have ten percent of their payment withheld.

Payment To Subcontractors Should Not Be Delayed By Procedures That Do not Involve Us

I believe another important aspect that has to be addressed is that all subcontractors bid projects and if they are the successful low bidder, they are contractually obligated to a fixed price. The general contractor agrees that his proposal, which includes all subcontractors, is in essence a time and material project not to exceed his original base bid.

This requirement theoretically justifies HUD's requirement of a cost certification prior to the retention release. If subcontractors are contractually obligated to their bid documents then I believe we should be paid the retention upon the finalization of our punch list and the effective date of substantial completion. There is no reason to hold ten percent or even five percent of an entire project amount because of final cost evaluation by the general contractor which includes wage review, certified payroll, and cost certification.

An additional problem could also develop due to the developer's possible overrun in construction costs. He, in turn, does not have to pay the interest until final closing. Or he might have cheaper construction financing in lieu of his upcoming permanent financing and it would be to his benefit to delay the closing as long as possible.

The mountain of red tape is further multiplied by repeating the same process 3 times. First the general contractor must cost certify the project. Then the developer must cost certify. Finally, the HUD office has to do the same before the retention can be distributed for payment.

Small businessmen cannot afford to continue dealing with the vast accumulation of governmental procedures that remain unhampered by constructive criticism. Retention is one of the worst deterents to profitability in the construction field.

The Structure of the Industry Has Changed

Retainage directly affects the various construction contractors which make up a major sector of our nation's gross national product. However, it also affects the many small businesses who contract for construction work by increasing their costs of construction.

In early days, government agencies usually dealt with a single general contractor who performed most of the construction work with his own employees. Agencies withheld a portion of each progress payment as leverage to insure that the work would be completed satisfactorily.

Today, more than 50% of the work is subcontracted to a wide range of different types of subcontractors. Performance bonds are required of the prime contractor to quarantee that the project will be completed satisfactorily. Likewise, prime contractors require performance bonds from their subcontractors.

However, retainage is still withheld from payments to the contractor to insure completion. Naturally, the prime contractor is not likely to pay his subcontractors from his own pockets and therefore he withholds a corresponding amount from them.

Survey Indicated Retainage Is Counter Productive

Recently, the NAPHCC completed an extensive survey, we call

Probe, of our contractor members on retainage (Attachment B). There are 5 major conclusions that can be drawn from the Probe that impact on retainage.

1. Retainage provides a duplicate layer of protection which the government pays a premium for.

   According to the results of the survey, 62% of plumbing-heating-cooling contractors admit that they increase their bids on construction work to cover the costs of retainage. The median increase was 3% of the contract price, but more than a quarter of the respondents indicated that their increases ranged from 5% to 15%. Contractors also add the costs of their performance bond to the bid. The median increase in bid was 1¼%. Thus, the government is paying a total of 4¼% over the actual costs of the construction contract for the dual level of protection. This is even more ironic since the federal government has been seeking to eliminate duplicative regulations to reduce costs.

2. Retainage is an unnecessary layer of protection.

   While proponents of retainage believe that it encourages completion of a contract, 63% of the contractors responding said that retainage is not an effective method to get contractors to complete the punch list. Thus, if it is not a motivating factor for the contractors who will do the work, it is obviously unnecessary.

3. The elimination of retainage will stimulate increased competition. Increased competition contributes to lower costs and a healthy economy. When asked if retainage were eliminated, would contractors be more likely to bid more

jobs, 52% said they would bid about the same as currently. However, a significant 48% said they would be more likely to bid more jobs. Retainage forces contractors to borrow money to meet the demands of the contract. Although a contractor must pay the bills of suppliers, meet his payroll and cover other overhead costs, he is not receiving full compensation for the efforts of his company. Many contractors borrow to meet those obligations until they have received those retained funds. With the elimination of retainage, contractors will have more financial flexibility to bid more jobs. This will increase competition for government contracts and bring costs down.

4. The elimination of retainage will free up valuably needed cash flow.

Survey results indicate that generally up to 10% is withheld from each progress payment. These are funds that are not available to the contractor for the conduct of his business. In fact, a contractor must run at a negative cash flow as he meets his supplier, labor and overhead obligations for fulfilling the contract. Thus, a contractor must borrow funds at current market rates to pay his bills until the retainage is received. If retainage were eliminated and full progress payments made, contractors would have the necessary operating capital for expansion, seeking new contract opportunities, and producing new jobs. This is a goal which is important to small businesses, but frequently restrained in contracting because of retainage.

5. Elimination of retainage speeds up job completion.

There is more urgency to complete a job if a contractor knows that full payment will be forthcoming quickly. The NAPHCC Probe found that the median delay in receipt of full final payment, including all retainage, after completion of work was 4 months. A quarter of the contractors reported waiting 7 months or more, as I have had to do. This is in addition to waiting for payment during the course of construction. Thus, a phc contractor is waiting a significant amount of time for money he is entitled to. These are funds which he has no access to for ongoing operations and, in fact, cannot even earn interest on.

Other subcontractors face a far worse predicament. Those contractors, such as masonry, who arrive at the construction site long before the phc contractor must wait still longer periods of time for their retainage.

If a contractor can expect to be paid in full for all work completed, that contractor is far more likely to complete the contract quickly to enable him to receive all payments as quickly as possible.

Bonding is the best protection

We believe that bonding should be used as the single, best source of protection.

Where there are no bonding requirements or where bonding requirements have been waived to assist struggling firms such as new companies or minority or female owned enterprises, the percentage retained should be as low as possible. Release of retained funds should be done on a line item basis with each subcontractor's work considered as a separate item so that such firms are not left waiting for final payment. Any retained funds should be held in an escrow account with interest accruing to the benefits of the contractor.

Furthermore, it is important to note that the practices of the federal government are watched and followed by state and local government and private owners. Therefore, a public policy decision enacted through this legislation would lead the way to the elimination of retainage on many types of construction. Thus savings experienced by the federal government as a result of elimination could be enjoyed by all small businesses who are planning construction work.

Adverse Effects of Retainage

Retainage severely restricts the cash flow of small businesses that can ill afford the added drain on our resources in this economy. Elimination of retainage will free up that cash flow, reduce borrowing requirements, especially at current high interest rates, and stimulate the economy.

The elimination of retainage will free up funds for operating capital for expansion, for seeking new contract opportunities and for producing new jobs. If retainage were eliminated, my company would be more likely to bid more jobs.

If retainage were eliminated, the cost of construction would be lowered. Contractors would not be borrowing to make up for outstanding retainage. This savings in the cost of borrowing would be passed on to the federal government through lower competitive bids. This is the reverse of the current situation in which contractors must increase their cost of bids to cover the costs of the duplicate layer of protection of both retainage and the performance bond.

Legislation Needs Flow Down Provisions

However, we do have one recommendation to significantly improve S.1782. The bill should have language which insures that the prime contractor also eliminates the holding of retainage for his subcontractors. It would be a sham to this entire legislative process if legislation were passed eliminating retainage on prime contracts, but not reaching beyond that. A prime contractor might be very tempted to withhold retainage on his subcontractors to earn interest on the funds. Meanwhile the benefits and savings are not passed on to the subcontractors and to the owners.

Conclusion

Mr. Chairman, as a small business contractor I urge the Congress to eliminate retainage. The practice of retainage unfairly and unnecessarily withdraws scarce cash flow from contractors. Instead, bonding should be used as the single, best source of protection.

Furthermore, any legislation to eliminate retainage should provide that the elimination applies to prime and subcontractors equally. Full payments for completed work should flow down to the subcontractors.

Thank you for the opportunity to express my views and I would be pleased to answer your questions.

Attachment A.

POSITION PAPER

ELIMINATION OF RETAINAGES

Retainage is the process under which a procuring agency will hold back part of the payment for work that has been completed as an incentive for a contractor to complete the job.

Elimination of retainages is an area that promises tremendous savings to the government. Traditionally, a certain percentage of payments are retained until construction is complete. This is to insure completion of the work. Naturally, the contractor factors this loss of use of funds into his bid. However, the contractor must also factor in the cost of his performance bond which insures completion of the work. Thus, by requiring both retainages and a performance bond, the government is paying for an unnecessary double layer of protection.

However, there is a significant body of opinion that believes both retainage and a performance bond are needed. Where retainage is held, the amount should be kept to a minimum. Contractors are obliged to pay higher interest rates on funds borrowed for working capital to offset retentions, thereby increasing construction costs. Therefore, retained funds, which have been earned by the contractor, should be placed in an interest bearing escrow account for payment to the contractor. Likewise, contractors should receive interest on late payments for all construction work completed.

RESOLVED

The Small Business Legislative Council supports Elimination of Retainages. Bonding shoud be used as the single, best source of protection. This should apply to prime and subcontractor equally, but where a company is unable to obtain bonding, retainage may be used as an alternative.

Where there are no bonding requirements, the percentage retained should be as low as possible, in no case more than 5%, until 50% of the work is completed, and then dropped.

The percentage level of any retention should be the same for subcontractors as for prime contractors on a job.

Release of retained funds and final payment, as well as figuring the point of reduction of retainage, should be done on a line item basis...that is, each contractor or subcontractor's work considered as a separate item.

Retained funds should be held in an escrow account with interest accruing to the benefit of the party to whom the funds are due.

Interest should be paid on late payments for complete work.

Attachment B

PROBE '82

A Survey of Plumbing-Heating-Cooling Contractors - March, 1982

Dear Friend,

The NAPHCC Legislative Committee has been working with our sister organizations to deal with the problems caused by retainages on construction contracts in the public and private sector. Toward this end, we ask for your cooperation by answering the following Probe.

Sincerely,

Leonard X. Farbman, Chairman
NAPHCC Legislative Committee

Legislative Committee

William L. Harvey
Charles R. Blank, Jr.
John Mirlicena
Karl Ruch
James E. Curry

Impact of Retainage

1. Do you believe that retainage is an effective method to get contractors to complete the punch list?

☐ Yes

☐ No

☐ Don't know/no opinion

2. Do you increase your bids to cover your expected costs of retainage?

☐ Yes

☐ No

☐ Does not apply

3. If yes, approximately how much? ________%.

4. If retainage were eliminated, how likely would you be to bid more jobs?

☐ more likely

☐ about the same as currently

☐ less likely

Amount of Retainage Outstanding

5. Approximately what share of your volume is from federal contracts?

Federal ______%

Nonfederal/other ______%

6. On the average, approximately what is the percentage of retainage withheld?

Federal ______%

Nonfederal/other ______%

7. Approximately what is your gross volume?

☐ less than $100,000

☐ $100,000 to $250,000

☐ $250,000 to $500,000

☐ $500,000 to $1 million

☐ $1 million to $2.5 million

☐ $2.5 million to $5 million

☐ $5 million to $7.5 million

☐ over $7.5 million

Published by the National Association of Plumbing-Heating-Cooling Contractors, 1016 20th Street, N.W., Washington, D.C. 20036 - (202) 331-7675

8. On this volume, how much cash is retained on the average?

$ ____________

9. On the average, how long is it held?

____________ months

10. Right now, how much retainage do you have outstanding (i.e. on which you are waiting for payment)?

$____________

Performance Bonds

11. Of your contracts that have retainage held what proportion also require performance bonds?

______%

12. What is the average cost added to your jobs for the performance bonds?

______%

Accounting Method

13. Which of the following accounting methods do you use?

☐ cash

☐ accrual

☐ completed contract method

☐ other (specify______________)

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JUNE 11-15, 1982
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---------------- Fold Here ----------------

From:

____

____

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Place
Stamp
Here

National Association of
Plumbing-Heating-Cooling Contractors
1016 20th Street, N.W.
Washington, DC 20036

Statement of

Arthur C. Meushaw

on behalf of

American Subcontractors Association

before

Subcommittee on Federal Expenditures,
Research and Rules
Committee on Governmental Affairs
United States Senate

August 18, 1982

AMERICAN SUBCONTRACTORS ASSOCIATION 8401 CORPORATE DRIVE, SUITE 540, LANDOVER, MD 20785
(301) 459-8494

Statement of
American Subcontractors Association

My name is Arthur C. Meushaw. I am president of Standard Acoustics in Washington, D.C.

I am first vice president of the American Subcontractors Association (ASA). I also serve as chairman of ASA's Government Relations Coordinating Committee and chairman of ASA's Federal Liaison Committee.

ASA is a national trade association with over 4500 members in virtually every state. ASA represents subcontractors in all the construction trades. ASA is genuinely an organization of, by, and for subcontractors.

ASA has also been asked to speak for the Association of Wall and Ceiling Industries - International with more than 800 members; the National Association of Elevator Contractors with over 300 members; and the Painting and Decorating Contractors of America with more than 4000 members. These associations are members of ASA's National Advisory Council.

Many ASA members perform construction for the federal government. Sometimes they serve as prime contractors, contracting directly with the federal government. More often, they serve as subcontractors, dealing with the government only through a prime contractor. In both situations, the retainage practices of the federal government have a direct and negative impact on these construction contractors.

Retainage is the practice of holding back a stated percentage, usually 10 percent, from each progress payment to be paid upon completion of either the contractor's work or completion of the entire project. Thus, as the contractor completes 100 percent of each segment of the contract, he receives only 90 percent of the agreed price for such completion. The retained monies may be held for months, or even years, even though the contractor's work has been completed and accepted by the construction project's owner.

Today, I am testifying on behalf of ASA in support of a bill (S.1782) that would require federal civilian agencies to eliminate unnecessary retainage on federal construction projects. The "Small Business Contract Payment Procedures Act" does not require the appropriation of a single penny from the U.S. Treasury. It would not lead to deteriorating contractor performance on federal projects. Yet it would give the beleaguered construction industry the kind of boost it so desperately needs.

Historically, retainage was withheld from contract payments for several reasons:

--to provide leverage against the contractor to insure that the contract is fully performed;

--to provide partial financial security for the owner if work was not completed in accordance with the contract;

--to discourage financially irresponsible contractors from attempting to perform the work;

--to save the owner the cost of interest on the amounts retained.

These reasons are no longer valid and today the construction industry is the only business in the United States that adheres to 10 percent retainage.

And, in this industry, retainage is used primarily as a substitute for good contract administration. Fortunately, there is a growing awareness among government agencies, private construction buyers, and builders of the need for modernizing this practice, with an eye to reducing unnecessary cost.

Many private companies have reduced retainage well below 10 percent or have eliminated it entirely.

Some states, including Washington, Virginia, South Carolina, North Dakota, and California, have also substantially reduced retainage.

Even the U.S. Department of Defense has adopted a policy that basically eliminates unnecessary retainage on military construction.

> As a matter of Department of Defense policy, retainage will not be routinely used throughout the term of contracts for construction projects which are on or ahead of schedule and otherwise substantially in compliance with contract requirements. Some level of retainage may be used as the contract approaches completion, however, to ensure that construction deficiencies are corrected promptly and that completion is timely. Further, in specific cases, where past unsatisfactory performance by a certain contractor has been experienced or there is another valid consideration relating to a particular contract, the Construction Agent may elect to withhold retainage throughout the term of the contract if that will be in the best interest of the government. Construction Agents are to exercise these options with discretion and for specific justification. Retainage will no longer be a routine administrative practice.
>
> This policy on retainage must be complemented by prompt and positive final payment procedure after a contractor has completed all contract requirements. This should improve our perception as a preferred customer by the construction industry and tend to reduce our contract construction costs even more.
>
> (Memorandum from Robert A. Stone, Deputy Assistant Secretary of Defense, dated February 8, 1982).

However, according to a recent ASA survey, the retainage practices of the federal civilian agencies are not so progressive.

GOVERNMENT RETAINAGE POLICIES

GOVT AGENCY	AVG % RETAINED THRU ENTIRE JOB	% RETAINED FOR 1ST QTR OF JOB	% RETAINED FOR 2ND QTR OF JOB	% RETAINED FOR 3RD QTR OF JOB	% RETAINED FOR 4TH QTR OF JOB
Interior Dept*	4%	10%	2½ %	2½ %	1½ %
GSA	5%	5%	5%	5%	5%
HUD	5%	10%	10%	Zero	Zero
Postal Service	5%	10%	10%	Zero	Zero
Veterans Admin	5%	10%	10%	Zero	Zero

*The Interior Dept permits contractors to post a deposit of negotiable interest-bearing securities in lieu of retained percentages.

Retainage Increases Government Costs

Inflation, high interest rates, budget deficits - whatever the reason, cost is the performance criteria that is currently of greatest concern to the government. It has been suggested by both the Office of Management and Budget (Letter to Senator William V. Roth from Naomi R. Sweeney, Assistant Director for Legislative Reference, dated July 9, 1982) and the Surety Association of America (Letter to William B. Montalto from Quentin W. Lerch, dated May 11, 1982), that the elimination of retainage would increase the cost of federal construction by forcing agencies to pay contractors earlier than is currently the practice. For example, SAA states:

> With no retainage, fiscal cost to the Government may be substantially increased by reason of having to make substantially earlier payments. That is doubly so when the government is

> forced to pay out in the earlier stages of the work over the next several years funds which they would not normally have had to pay out until nearly the end of the same contracts. These expenses would be further increased in those situations where the raising of such funds involves borrowed money at taxpayers' expense in the current interest climate.

By this reasoning, the government is asking the construction industry - primarily small businesses - to help finance its construction. Construction contractors are builders, not bankers. And when the government forces construction contractors to act as bankers, it will pay dearly for that service.

The withholding of retainage has forced many capable contractors to increase bids to the government in order to keep going until retainages are paid. Contractors do not have sufficient capital or borrowing power to cover a large amount of retainage. Nor is it good business for contractors to tie up indefinitely their working capital or borrowing power in retainage, which is nonproductive. Contractors, of necessity then, must recoup a portion of the negative cash flow created by retainage by increasing their prices to the government. Thus, it would seem that the government could decrease the cost of construction projects by eliminating or reducing retainage.

The necessity for a contractor to increase his price to cover a substantial portion of the retainage is most easily seen by describing the particular plight of the subcontractor who finishes his contract during the early phases of the construction. Early finishing subcontractors such as grading, foundation, steel erectors, and roofing subcontractors have a 10 percent holdback until the entire general contract is completed, and these early finishing subcontractors must normally wait for their retainage for one or two years. The early finishing subcontractors simply cannot wait that long to collect the 10 percent retainage holdback because they must pay for labor and material currently and must operate their business with normal overhead and profit currently. Therefore, they calculate their sale prices by adding for overhead and profit which will be paid currently out of the 90 percent progress payments and substantially discount the retainage that they will not receive for a year or two when the general contractor finishes the entire project. For example, if it takes a 20 percent indirect cost to run a subcontracting company, then an early finishing subcontractor will add a markup. Although a late finishing subcontractor does not have to wait as long after he finishes his work to receive his retainage, the effect on progress payments is still quite severe since the subcontractor must fund the 10 percent holdback progressively over the length of the contract.

Elimination of retainage would increase the cash flow of contractors enabling them to procure needed materials at an earlier date and at a lower cost. It would also relieve them of a portion of their interest burdens. These savings would filter back to the government through lower bids on future projects. In a survey conducted by ASA, 76 percent of the contractors questioned said they would reduce their prices on projects where retainage was eliminated. The same survey showed that contractors raise their bids by an average of 3.7 percent when retainage is withheld. Other studies have indicated that such savings would average between three and five percent.

It is obvious then that the short-term savings to the government in interim construction financing on retainage are more than offset by additional permanent financing costs for the entire project which include amounts added by prime contractors and subcontractors to their prices to cover the cost of carrying retainage over an extended period. Elimination or reduction of retainage would give potential bidders a means of reducing their bids on projects at no cost to the government.

Retainage Is Not Needed to Assure Contract Performance

The reduction or elimination of retainage would not increase the government's risk on construction projects since the Miller Act (40 U.S.C. 270) requires a government prime contractor to provide a performance bond in such amount as the contracting officer deems appropriate. This figure is usually fixed at 100 percent of the contract price. The prime contractor usually passes the bonding requirement on to the subcontractors. These bonds provide the government with a guarantee of full contract performance and full financial security. They also help to weed out financially unstable contractors.

We grant that some surety companies may tighten their bonding requirements in order to assure that unqualified contractors do not obtain government contracts. But, after all, that is what performance bonds are for.

The use of both bonds and retainage results in double protection in addition to the express and implied guarantees under the contract documents.

Retainage Reduces Bid Competition for Government Contracts

Retainage also deters many capable contractors from bidding on government jobs where retainage is required. They are simply reluctant to get involved in projects where they know they'll have to borrow money to pay bills because the government holds up money they have already earned. The result is reduced bid competition for government construction contracts and an increase in construction costs to the government.

Retainage Creates Construction Delays

In recent years, there has been increasing concern in government agencies over the failure of contractors to meet the completion dates for new federal buildings. Because of the rapidly increasing costs of labor, supplies, and equipment, such construction delays often force agencies to return to Congress for additional construction funds when projects are not kept within their budget limitations.

However, the argument that retainage is a necessary club for the government to wield in order to get the building completed on time is illusory. In fact, retainage frequently has just the opposite effect. Industry surveys confirm that by holding the full retainage until all punchlist items are completed by the prime contractor and all subcontractors, an individual contractor or subcontractor is simply not motivated to perform his punchlist when he knows that the punchlist work of others will delay payment of retainage to him for many months. The result is often a delay of project completion and an increase in costs.

Retainage Reduces Operating and Expansion Capital for the Contractor

The practice of withholding retainage from progress payments creates a serious negative cash flow for the contractor which becomes more and more burdensome as the work progresses. Contractors must pay for their labor weekly and their materials monthly or more frequently to obtain the various vendor discounts.

Contractors must also cover their indirect costs currently. It is a grossly unfair financial burden to withhold retainage until the government accepts the project as complete.

Contractors must cover retainage either by borrowing the money from financial sources to replace the retainage or funding the retainage out of working capital. If a contractor borrows the funds, he must pay interest at today's inflated rates. For example, in the case of a $5 million project that takes two or more years to complete, the contractor must borrow and pay interest, perhaps at two or three percentage points above the prime rate, on $500,000.

In an example from my own experience, during one month in 1981, my company had $3,414,000 in receivables. $1,005,000, or more than one-third, was in retainage.

It is obvious, then, that if retainage is funded out of working capital, the result is a complete withdrawal of working capital. As each contract is performed and retainage paid on that contract, another contract will normally take its place with a similar or greater amount of retainage.

Thus, retainage is not only contrary to the general principle that payment is due when performance has been completed, it promotes increased costs, credit problems, bankruptcies, and an entire realm of other negative factors. It is no wonder then that so many contractors have come to realize that retainage amounts due them have become a major reason for their financial problems.

Retainage Creates an Adversarial Atmosphere

Prime contractors and subcontractors are primarily interested in getting paid for work satisfactorily performed. When a contractor receives a progress payment less a percentage for retainage, he is getting less than full value for the work he has performed and he begins to wonder whether one party to a contract is capitalizing on the use of money earned by another. An adversarial relationship thus often develops between the subcontractors and the prime contractor and between the prime contractor and the government. This psychological effect works against a cooperative effort on the project. If the government agency is using high retainage as a means of leverage against the prime contractor, who passes along retainage to his subcontractors, this psychological effect may more than offset the benefits of such financial leverage.

Summary

When the government withholds retainage, it has no means to escape the problems created. When a contractor's costs go up, the government will pay - directly or indirectly. The government receives higher bids on its projects, in some cases substantially over estimate. On projects already under contract, where little can be done by the government to alleviate unanticipated contractor expense, the cost to the government may take the form of delay. A contractor who has lost most of his profit expectation in a job but who still has a lot of work to complete, poses another kind of problem to the government. A contractor cannot be expected to work for nothing and the government gets no "bargain" when a contractor is precluded from earning a reasonable profit.

Retainage, which involves billions of dollars, thus creates a vicious circle in which the government, prime contractors, subcontractors, and their employees all lose in the long run.

ASA strongly supports S.1782, the "Small Business Contract Payment Procedures Act," which would eliminate unnecessary retainage on federal government civilian construction projects. Elimination of retainage would lower government costs and accelerate cash flow into the economy. It would help the construction industry by infusing it with capital. And it would help construction workers who are the ultimate losers when a contractor goes bankrupt.

Senator DANFORTH. We will put the next panel off temporarily. The next witness is William Ferguson, Acting Assistant Administrator for Acquisition Policy of the General Services Administration. Mr. Ferguson, please proceed.

TESTIMONY OF WILLIAM B. FERGUSON, ACTING ASSISTANT ADMINISTRATOR FOR ACQUISITION POLICY, GSA, ACCOMPANIED BY HARMON EGGERS, CHIEF COUNSEL FOR DESIGN AND CONSTRUCTION, PUBLIC BUILDINGS DIVISION, OFFICE OF GENERAL COUNSEL, GSA, AND WALTER E. HUBER, CHIEF, PROJECT OPERATIONS BRANCH, DESIGN AND CONSTRUCTION DIVISION, NATIONAL CAPITOL REGION, GSA

Mr. FERGUSON. Let me introduce the two people with me today. One is Mr. Harmon Eggers, who is chief counsel for design and construction plans in our central office. Also with me is Mr. Walter Huber, who is Chief, Project Operations Branch, Design and Construction Division of the National Capitol Region.

Mr. Chairman and members of the subcommittee, it is with great pleasure that I appear here today to discuss the General Services Administration's position on the proposed legislation.

S. 1782 and H.R. 5022 both mandate the use of a single method for making progress payments; namely, as the work proceeds. The words at issue are apparently taken from the Federal Procurement Regulations [FPR] clause for construction contract progress payments. In our view, they infer the type of progress payment arrangements peculiar to construction contracting. However, it is a mistake to assume that this one method can be used in every contractual situation where progress payments are appropriate. The FPR and the Defense Acquisition Regulation [DAR] devote a whole section to progress payments based on costs incurred. This method is entirely different from the construction contract method which is based on estimates of contract completion. The use of the one method of making progress payments for all contracting situations involving progress payments is undesirable considering the diversity of these situations.

I must also add that the new FAR [Federal Acquisition Regulation] will also contain language similar to the FPR, as well as the DAR.

Utilization of the construction method for making progress payments relies solely on the use of estimates. Such estimates are inherently imprecise. In the FPR, the proposed method is used only in construction, shipbuilding, ship conversion, alteration, or repair. In all other circumstances, this method is used only when progress payments based on cost cannot be practically employed. The FPR recognizes that using such a method for other contracts does not provide optimum protection to the Government in administering progress payment provisions. Consequently, authority to use such a method must be obtained from the head of the procuring activity. Because the proposed method would require increased administrative safeguards, the use of this method in all contract situations would significantly increase the administrative burden on Government contracting activities.

The only change from the current construction contract provisions called for under section 2, paragraph (d)(2), is the substitution of the word "shall" in line 13 for the word "may," but it is a significant change. It would remove from the contracting officer all discretion as to the matter of full payment. The retention of a small amount is consistent with commercial construction contracting practice and serves to preclude overpayments and as an incentive to complete a variety of contract requirements, including defects and omissions at the end of the project, submission of Davis-Bacon payrolls, completion of maintenance manuals, record drawings, et cetera—all of which are hard to obtain in a timely fashion without the leverage of a retained amount. We believe that it is desirable for the Government to retain the flexibility to vary the amount of retainage on construction contracts in accordance with the circumstances of the contracting situation.

With respect to progress payments based on costs, present regulations provide for progress payments of 80 percent of total costs for other than small businesses and 85 percent of total costs for small business concerns. An FPR amendment is in the final stages of processing at this time that will increase these standard percentages to 90 percent for other than small businesses and to 95 percent for small businesses. These increases will make the progress payment allowances uniform with those recently promulgated by the Department of Defense. We believe that increased standard progress payment rates will go a long way toward alleviating the burdens on contractors of high interest rates while still retaining a measure of protection to the Government not afforded by the proposed legislation.

With regard to section 2, paragraph (d)(3), we are strongly opposed to elimination of satisfactory progress as a requirement for making full payments; that is, no retainage. The proposed statute would require full payment on all construction projects over $25,000, whether or not progress was satisfactory. That would severely hamper the contracting officer's ability to manage the contract. It is wrong to assume a performance bond takes care of the problem. A bond assures eventual payment for the cost of completion; it does not result in timely completion. In addition, sureties have questioned their liability where overpayments have been made to defaulting contractors. This provision would bring disorder into the contracting process and should not be adopted. While this provision would apply only to contracts with small business firms, almost all of GSA's construction is performed by such firms.

In addition, while a performance bond may provide the Government with some assurance of financial protection under a contract, it may not be helpful to small businesses. It may cost more money to the small business to obtain a performance bond, particularly where bonding companies think small businesses are greater risks. We can visualize situations where the higher cost of performance bonds to small businesses could result in awards to large businesses where they are competing head to head for the same contracts. The FPR provides special consideration for small businesses in the progress payments area. Specifically, it allows for a smaller retention percentage, and it permits limiting progress payments to small business concerns in furtherance of the stated purpose of Public

Law 85-800—FPR 1-30.504-3. Finally, the use of a performance bond may not be practical in a production or R&D contract, because it would be difficult if not impossible to get another company to pick up where the original contractor stopped in contract performance.

On a trial basis from 1974 to 1978, GSA's Public Buildings Service totally eliminated the 10-percent retainage from progress payments under all construction contracts. This was designed to improve the contractor's cash flow position during a period of depressed economic conditions. It was anticipated that the new policy would increase competition on Federal construction projects as well as enable contractors to expedite the work by providing them with additional operating capital. It also was anticipated that a portion of the contractor's savings would be realized by GSA through lower bids on construction projects.

GSA was disappointed in the test results. No measurable reduction in the bid prices was realized. Furthermore, prime contractors continued to withhold progress payments from their subcontractors, thereby negating any improvement in the subcontractor's cash flow position. In addition, contracting officers became increasingly concerned over the loss of the most effective tool to insure timely project completion; that is, the retainage lever. Therefore, it was concluded that some reasonable retainage policy was essential in order to improve project completion and to minimize the risk of overpayment to contractors and subcontractors.

In summary, we believe that existing and forthcoming procurement regulations provide adequate flexibility for meeting the needs of small business concerns with regard to the use of progress payments and that legislation on this matter is not required.

This completes our prepared remarks. We would be happy to answer any questions.

Senator DANFORTH. Mr. Ferguson, is the present policy of the Government relative to retainage a flexible policy or an inflexible policy?

Mr. FERGUSON. In our opinion, there is flexibility in it. As a general rule of thumb, we hold back 10 percent of most of our contracts at the outset to the 50-percent mark. Assuming progress is being made on an appropriate basis, we drop that to 5 percent. Generally, you will find that 5 percent will hold true throughout the rest of the contract. We do have the flexibility in the FPR to go to a lower amount if we so choose.

Senator DANFORTH. I am not in the construction business. You may have to help me with this.

When you enter into a contract, there is a 10-percent retention, is that correct?

Mr. FERGUSON. That is right.

Senator DANFORTH. In some cases, that is subsequently reduced to 5 percent.

Mr. FERGUSON. That is generally at the 50-percent completion mark.

Let us assume for a second, Senator, that you have a $1 million contract. Through the first $500,000 claimed against that of costs, we would hold back 10 percent. At the halfway point, we would have approximately $50,000 held back. If completion is satisfactory at that point, then we would release in some instances $25,000 of that and continue to hold 5 percent throughout the rest of the contract. Of course, the $25,000 will grow back up as time goes by through the latter half of the contract. In some cases, you will find that we hold back a flat 10 percent all the way through. We have that flexibility.

Senator **DANFORTH**. Do you invariably hold back 10 percent for the first half of the contract?

Mr. **FERGUSON**. Generally speaking, within GSA we do.

Senator **DANFORTH**. Are there any circumstances when you do not hold back 10 percent?

Mr. **HUBER**. I think I can address that. As a general policy, we do hold back 10 percent on just about every contract. If a contractor has satisfactory performance and has a history of finishing his jobs ahead of schedule, then the contracting officer has the latitude not to hold retainage at all under the FPR. He has done so in several cases.

Senator **DANFORTH**. However, in just about every contract, it is 10 percent for the first half.

Mr. **HUBER**. I would say as a general answer that, as each month comes up, a 10-percent retainage is withheld of the payment which comes due. That is cumulative.

On most contracts which run for an extended period of time, most contracting officers—the old FPR used to say that he should hold 10 until he reached 50 percent. If the progress is satisfactory, the contracting officer would have the option at that time to stop holding retainage.

Senator **DANFORTH**. Then, is it the general practice to withhold 10 percent for the first half of almost every contract?

Mr. **HUBER**. Yes, sir, it is—as a general rule.

Senator **DANFORTH**. Would it be a rare exception to withhold less than 10 percent?

Mr. **HUBER**. I would say it would be rare.

Senator **DANFORTH**. With regard to dropping down to 5 percent when the contract is halfway completed, is that the general rule or is that the exception?

Mr. **HUBER**. I think to answer that properly, we have a lot of contracts which are of a short duration. Short-duration contracts, such as a 30-day contract, do not have retainage as a big issue. If a man finishes his job and everything is complete, you could actually pay him off in one payment. On contracts which run longer than that, you may hold a retainage for a little while and then pay him off completely.

Mostly, contracts which run for an extended period—that is, the larger contracts—would have the retainage of 10 percent held until he reaches 50 percent completion and then at that time either fix the retainage at a fixed amount and not hold any additional or, in some cases, reduce it to 5 and hold the 5 or just continue to hold 5 throughout the contract.

In other words, it is at the discretion of the contracting officer based on what he thinks is prudent, considering the performance of the contractor involved, the complexity of the job, and the protection of the Government's interest.

Whereas, the bill as I read it——

Senator DANFORTH. What is the general rule? I am just talking about long term contracts. What is the general rule once it is halfway completed?

Mr. HUBER. I would say generally it is to fix the retainage at that point, whatever the amount is at that time, which would be 10 percent of half the contract because the job is half finished, and then sit on that amount until substantial completion.

Senator DANFORTH. It would remain at 10 percent.

Mr. HUBER. It is 10 percent of 50 percent. The money stays the same, as a fixed amount, and the percentage decreases as you go from 50 percent completion to 100 percent completion of the contract.

If you take his $1 million example, if you hold 10 percent of $500,000, you hold $50,000. If the contracting officer fixes the $50,000, when the man becomes 100 percent finished, it is $1 million, and $50,000 is only 5 percent of that. The percentage decreases, but the amount is fixed.

The contracting officer also has the option, if he wants to, to reduce that retainage to some lesser amount if he feels it is appropriate.

Senator DANFORTH. Is that the general practice, that which you just described?

Mr. HUBER. The general practice, the most consistent one, would be 10 percent retainage to 50 percent completion and then hold the fixed amount until substantial completion.

Senator DANFORTH. To what percentage of the contracts, longer term contracts, would this practice apply?

Mr. HUBER. I would say it would be 90 percent of them.

Mr. FERGUSON. It is certainly the large majority of them.

Senator DANFORTH. Do you believe in retainage? Do you think it is important for the Government to have retainage?

Mr. FERGUSON. I do absolutely. I believe that our experience back in the mid-1970's shows that we should retain it.

Senator DANFORTH. You do not agree with Senator Weicker?

Mr. FERGUSON. No, I agree with him to the extent that I think we should have flexibility. It should not be a hard-and-fast rule of 10 percent.

Senator DANFORTH. It does not sound very flexible to me if 90 percent of the contracts are done in exactly the same way.

Mr. FERGUSON. I cannot disagree with your statement.

Senator DANFORTH. Is it the Government's position that whatever flexibility there should be can be provided by regulation?

Mr. FERGUSON. Yes.

Senator DANFORTH. Is there a proposal for a change in regulations to accomplish that?

Mr. FERGUSON. At the present time there is not.

Senator DANFORTH. Is the Government's policy on retainage the same as the private sector's policy on retainage?

Mr. FERGUSON. We think that in the main it is. They have a retainage themselves.

You heard the gentlemen just prior to us talk about retainage of the subcontractors' fees. I think it is similar to that.

Mr. HUBER. I think that is correct. The private sector holds back money also.

I think that a private person holds money back on a oontractor if he has work done on his home. You would not pay him off completely unless you knew him and you felt very secure that he would finish the job for you. You would hold back something to protect yourself.

Senator DANFORTH. Would you hold 10 percent?

Mr. HUBER. I would not go as far as to say that 10 percent is the right amount. Obviously, with the economic times as they are, 10 percent has become pretty harsh.

However, there should be a percentage of some kind with discretion on the part of the person holding the contract. Given the way I read the bill, that discretion is taken away from the contracting officer. As I read it, if it is a small business, he must pay in full, which means that if the man fails to perform—and there are some subcontractors who fail to perform——

Senator DANFORTH. Let me say that I do not think that this bill will end up being as inflexible as you suggest. I do think that what you have described as a flexible Government policy does not sound very flexible to me. It sounds like a rule of thumb which is almost always followed.

Mr. FERGUSON. I think that the policy itself is flexible. Maybe in practice we have not been as flexible as we could have been.

Mr. HUBER. I think there is a reason for that. GSA had a 10-percent policy, then a zero-percent policy, and then a 5-percent policy. Now there is the present policy. There is a bit of confusion.

What our contracting officers have done is to go back to the old 10-percent policy because they found it to be effective. Then at 50 percent completion, they fix the amount thus far retained and sit on it.

Senator CHILES. Is it effective, or is it easy for them?

Mr. HUBER. Obviously, some things are easier than others. There are many individuals we are talking about, in the hundreds. It gives them something which they can use against a contractor if he fails to perform. If the new bill were inflexible and said they must pay him off, it would take a tool away from the contracting officer. Then he would get into many disputes with the contractor over whether the work is actually satisfactory or not. The retainage gives him a tool, which is now proposed to be taken away.

Senator DANFORTH. At other hearings, we received a lot of testimony to the effect that people do not want to do business with the Federal Government for a variety of reasons. For example, specifications for supply items are so detailed that they do not make any sense in practical commercial terms. People do not want to operate under that situation. Recently, we had to pass a late payments bill because the Federal Government is not very good at paying its bills on time. Most business people do not want to operate under the needlessly costly circumstances that seem to pervade Federal procurement practices.

Isn't the current retainage practice another deterrent to doing business with the Federal Government? Is it just another red light which we flash at the business community, saying "Look, if you want to do business, do not look to Uncle Sam"?

Mr. FERGUSON. Obviously, I could be argumentative. I personally don't think that it is. As we said a few minutes ago, industry operates in the same general mode. I think prime contractors operate much the same way as we do in their relationship with subs. We aren't changing the practice. It could be argued whether it should be 1 percent, 10 percent, or 25 percent as the retainage. That is arguable.

I don't think that it is a red flag not to deal with the Government. It isn't easy to deal with the Government for many reasons. There are many laws and regulations which you have to deal with when you deal with the Government. In the private sector, you don't have to deal with those aspects of it. It is not easy. I would be the first one to admit that.

If you look at the procurement regulations, there are probably 4,000 changes in the regs in the last 20 or 25 years. It is hard to keep up with that. It is very expensive for businesses to keep up with the regulation changes, but that is how it is.

Senator **Danforth**. Senator Chiles?

Senator **Chiles**. I notice that in your statement you talk about: "* * * while a performance bond may provide the Government with some assurance of financial protection * * *, it may not be helpful to small businesses." Nothing in this bill does anything about waiving the performance bond.

Mr. **Ferguson**. I realize that.

Senator, I think what we were thinking of there was the implication of a performance bond taking the place of retainages. We agree that eventually we could have the jobs paid for if someone defaulted or we had to bring somebody in. The question here is timeliness. We think that the leverage which we have with retainages gets the buildings completed in a timely manner. That is very important to many, many people.

Senator **Danforth**. Thank you very much.

The next witness is Robert Stone, Deputy Assistant Secretary of Defense.

TESTIMONY OF ROBERT A. STONE, DEPUTY ASSISTANT SECRETARY OF DEFENSE FOR FACILITIES, ENVIRONMENT, AND ECONOMIC ADJUSTMENT, DEPARTMENT OF DEFENSE

Mr. **Stone**. Good morning, Mr. Chairman. I have a short statement which I would like to read.

I am pleased to appear before your committee to discuss retainage of payments on military construction contracts. Retainage, as you know, is the withholding of a percentage of a contractor's request for payments until the contract is satisfactorily completed.

In the past, the Department of Defense's practice was routinely to retain up to 10 percent of progress payments for completed work. But we talked with industry and other Federal agencies and concluded that this retainage was always adding cost to our contracts but not always adding value. The added cost was the interest that contractors were incurring on the loans they carried to make up the withheld funds. We further concluded that our retainage practice tended to reduce competition on our projects by discouraging some contractors from bidding on our work.

The retainage practice is a useful tool on many contracts to insure that the contractor completes his work. However, we concluded that in many cases careful management during the contract could just as well insure successful completion. Management would have to exercise caution in not making progress payments that were not justified. A contractor should be paid only for satisfactorily completed work. Management might need some retainage in the final stages of a contract to encourage the contractor to complete his work in a timely manner.

We issued a new statement of policy in a letter of February 3, 1982. The new policy eliminates the routine use of retainage for construction projects that are on or ahead of schedule and are otherwise substantially in compliance with contract documents. Our policy does permit management to retain some level of payment as a contract approaches completion to insure that construction deficiencies are corrected promptly and that completion is timely.

We recognize that there may be specific reasons on certain contracts to retain payments. In cases where a contractor has performed poorly in the past, for example, management may elect to retain some payments throughout the term of the contract if that will be in the best interest of the Government. This exception is to be used with discretion, however, and only for specific justification, not as a routine matter.

We expect to save money on military construction because of this new policy, but I would like to put the savings in perspective. I think the savings are likely to be in the neighborhood of 1 percent or so. I have heard much bigger numbers, and I cannot justify them. I think it would probably cost us more to try to find out exactly what we are saving than we could ever hope to save. Our new policy will make us a better customer. It will decrease costs to our suppliers. That is why we want to do it.

If we look at a typical military construction project that lasts 18 months, and if we retain money throughout, then we could retain up to 10 percent of the contract price an average of 9 months. If the contractor borrows that amount at 20 percent interest, he would incur an interest cost of three-quarters a year times 20 percent, or 15 percent of what we retain.

If our retainage is 10 percent, the interest cost would be about 1½ percent of the contract. So, if our policy were to retain nothing and all other factors remained the same, we would expect to reduce the contractor's and, therefore, the Government's cost by about 1½ percent.

Now, in fact, we are not going quite that far because, first, we didn't retain 10 percent on all contracts and, second, our new policy does allow some retainage. Furthermore, we don't know how much working capital contractors actually borrow, and we have made no estimate of future interest rates. So, we know our savings will be less than 1½ percent of our total program cost, but I hesitate to pin it down more closely than that.

Our new policy should increase competition. Increased competition should result in lower bids.

Because our policy is still quite new, we have no actual results from its implementation. The policy applies to contracts now being awarded but not to those that were underway when the policy was issued.

Gentlemen, that concludes my remarks. I will be pleased to answer any questions you may have on our policy.

Senator DANFORTH. Did you change your policy prior to 6 months ago?

Mr. STONE. Yes.

Senator DANFORTH. Prior to that, was retainage the rule, and now it is the exception? Is that the system?

Mr. STONE. It was the routine practice before. It is no longer routine. Some time later this year, we will try to get the kind of answers you are looking for from the administration's witness. It is no longer routine practice. The only strong inference I can make as to its implementation is that we are not getting letters of complaint. I think we have received one letter of complaint. That is usually a pretty good way of finding out whether or not your policy is being followed in the field.

Senator DANFORTH. Is there anything about construction contracting by the Defense Department which makes it different from the rest of Government?

Mr. STONE. I think, with respect to managing construction projects and the use of retainage, it is a useful tool to us. For the same reasons that it is useful to us, it would be useful to GSA, the Postal Service, or whatever other governmental agencies there are.

Senator DANFORTH. You do not see anything different about Defense Department construction which would make a more flexible retainage policy workable for the Defense Department but not for the rest of Government?

Mr. STONE. No, sir, I do not see any difference.

Senator DANFORTH. Thank you very much.

The next panel will consist of Paul Jones, Robert Watkins, and Gordon Cochran. Mr. Jones, would you like to begin?

TESTIMONY OF G. PAUL JONES, JR., PRESIDENT, MACON PRESTRESSED CONCRETE CO., ON BEHALF OF THE PRESTRESSED CONCRETE INSTITUTE; ROBERT WATKINS, PRESIDENT, AETNA DRYWALL CONTRACTORS, INC.; AND GORDON COCHRAN, COCHRAN ELECTRICAL SERVICE CO., ON BEHALF OF THE NATIONAL ELECTRICAL CONTRACTORS ASSOCIATION

Mr. JONES. Thank you, Mr. Chairman.

I have given you a statement. I will not read it, but I will summarize it.

I think retainage was developed to provide the incentive, as has been talked about earlier, to finish a job on time, with quality products and with quality service. However, the net result of it has been, as has been pointed out, that the general contractor has a 10-percent retainage in his contract until it is 50 percent completed. At the end of the contract, he only has a 5-percent retainage.

On the contrary, the general contractor retains a full 10 percent from each of his subcontractors. This applies to the foundation contractor and other subs working at the beginning of the job. They may not even visit the job during the last 50 percent of the construction period.

The result is that, at the completion of the contract, the general contractor has only 5 percent of his money retained, but he is retaining 10 percent from all of his subcontractors, including those who come in at the end of the job. He will not have any more money retained from him, but those contractors—the finishing contractors, the painting contractor, the acoustical contractor—who come in at the end of the job will still have 10 percent retained.

What was initially intended as an incentive has become a disincentive. He has to go into his money market fund at the bank in order to pay his subcontractors when his retainage is released.

I think another reason for the retainage was lack of necessity for the inspecting officers—the owners' representatives, the architectural engineers, or the contracting officer—to be precise in their estimates of progress payments. They have now a plus or minus 10 percent leeway for error. I guess you could make a pretty good argument that they do not need to be precise to the last penny, but they should have a 1- to 3-percent margin of error to be more realistic.

I think what was pointed out by the representative of DOD was that this leads to poor management and lax management. Retainage has become a crutch to go out and make a reasonably close estimate without spending a bit more time and effort to make a more precise estimate.

The results have been high costs to the owner. Another result is that it is borne by the subcontractor, particularly the small subcontractor. There aren't too many small businesses which contract directly with the Department of Defense, but a lot of them are subcontractors in large construction contracts. They bear the brunt of the retainage provision.

It has been pointed out that this is a tradition in the private sector. I feel that the elimination of retainage from contracts with the Federal Government would probably begin to phase it out in the community and would give at least the general contractors and some of the subs the ability to say: "The Government doesn't do it any more. Let's stop doing it in the private sector." It would provide a vehicle which would allow us to go to the private sector and establish a similar policy on retainage.

Finally, Mr. Chairman, most contracts between a general contractor and a subcontractor have a provision that the terms of the contract which the general has with the owner also apply between the general and the subcontractor. If the retainage clause is eliminated, it would give subcontractors the opportunity to negotiate and to be aggressive in their negotiations. They could say: "You aren't having the money retained by the Government or by the owner. We don't want the money retained from us."

For that reason, I oppose the government's directing the general contractor to pass this through by statute. I think that is an intrusion into the private contractor's rights. I think that is more regulation by the Government. While it would help me and I would like to see retainage eliminated, I think it is up to me to negotiate that with my general contractors.

I appreciate the opportunity to testify and will be happy to answer any questions.

Senator DANFORTH. Thank you, sir. Without objection, your prepared statement will be inserted in the record following the testimony of this panel.

Mr. Watkins.

Mr. Watkins. Mr. Chairman and members of the committee, I am Robert Watkins, president of my own corporation, the Aetna Drywall Contractors, Inc., of Fort Lauderdale, Fla. I do business primarily in the State of Florida. My company is a specialty contractor doing drywall, plastering, lathing, acoustical ceilings, fireproofing, and so forth. Our annual volume is approximately $20 million. I have 25 years of experience in the construction industry. I started in St. Louis, Mo. I have spent the last 14 years in Florida.

Obviously, I am here in support of S. 1782, the Small Business Contract Payment Procedures Act. If passed, this bill would eliminate unnecessary retainage on Federal civilian construction projects.

My fellow contractors have already supplied the subcommittee with the statistical data to support S. 1782. Therefore, I would like to take this opportunity to explain how retainage impacts on a typical specialty contractor like Aetna Drywall.

I have served as a subcontractor on numerous Federal construction projects. For example, my company is currently involved in a Federal contract in St. Thomas worth about $5 million. The amount of money being withheld from this contract in retainage is about $425,000.

I have found that the amount of retainage withheld by the Federal Government is always 10 percent. To my knowledge, no agency withholds more than 10 percent. Nonetheless, this amount is greater than the total amount of anticipated profit on most Federal construction projects.

I can state from personal experience that the withholding of retainage from progress payments places a severe restraint on the operations of a construction contractor. Its impact is often staggering. Let me explain.

I am not paid for work which has not been performed satisfactorily. My work must be inspected and approved before I receive payment for it. Any money withheld from progress payments is money that is owed to me for materials already supplied and for work already performed.

The retained funds are not returned to me, even when my work on a project is completed and finally accepted. On each job, I do not receive final payment until from 90 days to 120 days after the project—and I emphasize the word "project"—is completed, or a total of 150 to 180 days after my company has completed its work and has left the project site. In one case, the Government had beneficial occupancy of the building for 6 months before the retainage was released.

Thus, when I do business with a Federal civilian agency, I become an involuntary banker for the Government. I am forced, through the practice of retainage, to lend the Government interest-free money for months at a time.

As a result of this diversion of cash flow, contractors like Aetna Drywall are faced with several choices: They are to borrow money to finance the retainage, to postpone plans for expansion, to lower profit expectations, to avoid bidding on projects that require high retainage, or to increase the bid in order to absorb the losses caused by retainage. Usually contractors, including Aetna Drywall, resort to a combination of these; but no matter how the contractor chooses to deal with the problem, the customer—in this case the Government and indirectly the taxpayer—pays.

I would like to emphasize this. In busy periods, contractors like myself will avoid bidding on Government work when we can do work in the private sector and not have the problem of retainage involved in federally funded work.

No matter what a contractor has to do because of retainage, the Government and the taxpayer pay the bill. If I borrow money, it goes into my bid. Obviously, it inflates my bid by that amount of money. It has to be that way.

As you all know and as the other witnesses have testified, on all federally funded work, payment and performance bonds are in effect. If I do not perform my contract satisfactorily, the Government not only continues to withhold retainage but is also protected by a 100-percent performance and payment bond. The bond, which under the Miller Act is required to be posted by the prime contractor, inflates the contract price by at least 1 to 2 percent of the bid price. The prime contractor usually passes the bonding requirement—like most other contract requirements—through to the subcontractor. The Government thus pays a premium for double protection, the cost of the bond and the cost of borrowing the retained funds from the contractor.

I strongly urge the members of this subcommittee to actively work for final passage of S. 1782. The bill, by eliminating unnecessary retainage, would improve the current cash position of contractors doing business with the Federal Government, improve the bonding capacity of such companies, reduce their accounts payable, reduce their interest expenses, improve their credit standing, and increase employment. At the same time, the bill would allow Federal contracting officers the flexibility of withholding retainage when contract performance is unsatisfactory or in other special circumstances. The bill would also benefit the Federal Government by reducing the cost of Federal construction, increasing competition for Government contracts, and reducing disputes on Government construction projects.

Security is not jeopardized at all. The security which the Government has is the 100-percent payment-performance bond plus the fact that they are always holding 1 month's payment. For example, in the month of July, I submit a requisition. I do not receive my money until the end of August. By that time, I have worked all of August. They really have 1 month of my money at all times. On top of that, a third form of security is that if I do not perform they have the right to withhold retainage.

They have three things: the bond, 1 month's payment, and the right to hold retainage.

In conclusion, I would like to make two passing comments. In the private sector, over the past 2 years in Florida, there has been a dramatic change in the retainage policy. Private developers and the State and local governments have been eliminating or substantially reducing retainage for the purpose of picking up cost savings.

Gentlemen, that concludes my comments.

Senator **Danforth**. Thank you very much.

Senators Mattingly, Chiles, and Nunn have other meetings which they have to attend. They want to put some questions to you, Mr. Jones and Mr. Watkins, at this point. I will hear from you later, Mr. Cochran.

Senator **Mattingly**. Thank you, Mr. Chairman.

First, I have a statement which I would like to submit for the record. It states that we are solidly behind you. I think that the more rapidly we can pass the legislation the better off you will be.

Senator **Danforth**. Without objection, your statement will be inserted in the record at this point.

[Statement of Senator Mattingly follows:]

OPENING STATEMENT OF SENATOR MATTINGLY

Mr. Chairman, I wish to commend the chairman for holding hearings today on this issue. I feel that The Small Business Contract Payments Procedures Act is a bill that this Congress should adopt as soon as possible, and I am very pleased to be a cosponsor of this piece of legislation.

The Federal Government's indiscriminate retainage of progress payments to small businesses has had unfavorable impact. It has not worked as the carrot to induce contractors to complete Federal work in a timely fashion; indeed, many feel that it has worked against such efforts. But most important, it has put the pinch on small businesses that are involved in Government contracts.

It was never the intent of the Federal Government to create such an unreasonable cash flow problem upon the small businesses with whom it does business. Along similar lines, I supported the Prompt Payments Act, which ended the Government's practice of neglecting to pay businesses who dealt with the Government, and incurring no interest costs for such delay.

This legislation is an important first step in correcting Federal retainage procedures. Congress should move rapidly to accept this legislation because of the positive and dramatic impact its enactment will have upon small business, especially contractors.

But the most persuasive reasons for quick passage of S. 1782 is that it will help the American taxpayer most of all. As many of the people before this subcommittee will testify today, the effect of the retainage provision has been to build higher costs into Federal projects. The true cost of this form of "withholding tax" is once again paid by the average taxpayer; and not the organization that the government claims to be taxing. There is absolutely no reason for the taxpayer to have to carry this load. As outlined in S. 1782, there are more reasonable methods to assure satisfactory performance from a contractor on a federal project.

I look forward to hearing the testimony from our panelists today, and will work with Senators Danforth and Weicker to see that proper legislation is enacted in this area.

Senator **Mattingly**. I do have a couple of questions to ask Mr. Jones.

Is there a percentage of the retainage withheld by the general contractor from his subcontractors, just as there is a percentage of retainage withheld from the general contractor?

Mr. **Jones**. It starts off that way. The general contractor has 10 percent retained. Usually, at the 50-percent mark he has no more retained until the end of the job, but he retains 10 percent from those subcontractors and suppliers who come on the job in the last half, with a net result that, as a general statement, he is holding 10 percent from all of his subcontractors at the end of the job. The Government is only holding 5 percent from him at the end of the job. He is using the money, and he is primarily using the money of the subcontractors who come in early, the ones who start at the beginning of the project.

Senator **Mattingly**. Can the general contractor utilize the money withheld from the subcontractor?

Mr. JONES. He can invest it in the financial market.

Senator MATTINGLY. Do the subcontractors receive any interest on the funds withheld?

Mr. JONES. No, sir, they do not.

Senator MATTINGLY. Is there a delay between the time when the retainage is released by the Federal Government to the general contractor and the time when the general contractor releases the money to the subcontractors? Was that what Mr. Watkins referred to?

Mr. JONES. As has been previously pointed out, you have all sorts of people in the subcontracting and general contracting business. Some are more assiduous than others in paying their subcontractors promptly.

The situation we have now is that it becomes a disincentive for the general contractor. He is withholding more money from his subcontractors than is being withheld from him. Therefore, there is some reluctance on his part to complete the job.

If we know precisely when the general contractor has received his money from the owner, then we will begin aggressively pursuing it. It will usually take 30 to 60 days to get it.

Senator MATTINGLY. If we put this bill into law, there would be an incentive where there is no incentive now, is that correct?

Mr. JONES. I am opposed to the Government's trying to dictate private contracts as a matter of principle. I do think, however, if the retainage provision is removed from the contract between the Government and the general contractor, it will give subcontractors a vehicle to go back and say: "You don't have any retainage. We don't want any either." Some will be more successful than others in succeeding in the negotiations, but it will form the basis of a fair and equitable negotiation and a revised subcontract.

All the contracts now say is that all of the terms between the owner, the Federal Government in this case, and the general contractor will apply equally to the general contractor and the subcontractor. If the retainage provision is removed, it will give us a vehicle to dicker with him.

Senator MATTINGLY. Mr. Watkins mentioned computing the retainage into the bid. Is that done?

Mr. JONES. Yes, sir. I think that anyone who is realistic has to compute his interest costs and his other financial charges into his cost analysis.

Senator MATTINGLY. Therefore, the cost of doing business with whomever you work will go down, is that correct?

Mr. JONES. I think that should follow.

Senator MATTINGLY. I can assure you that we will do everything that we can to get this passed as rapidly as possible. As you well know, sometimes this place moves like concrete.

Mr. JONES. I recognize that you have a lot of things on your agenda which may have a higher priority than this particular bill, but it is very important to the construction industry, which is probably the most depressed industry in the country right now. We have higher unemployment than any other industry.

Senator MATTINGLY. Thank you very much.

Thank you, Mr. Chairman.

Senator DANFORTH. Senator Chiles.

Senator CHILES. In your statement, Mr. Watkins, you said that you often wind up with a 10-percent retainage in the Federal contracts. What is your normal profit level on the contracts?

Mr. WATKINS. The average profit is about 5 to 6 percent. That is an industry average, and I find that it holds true in Florida also.

Senator CHILES. You actually have more retained than you have profit in it?

Mr. WATKINS. Yes, sir, that is correct.

Senator CHILES. We heard GSA say that there are some agencies which are retaining less than 10 percent. Do you know of any Federal agencies in Florida that are retaining less than 10 percent?

Mr. WATKINS. That has not been my experience at all in Florida. It has been 10 percent on what we have done.

Senator CHILES. Do you know of anyone else?

Mr. WATKINS. I have no personal knowledge of it, Senator.

Senator CHILES. You say that there has been a change in the private sector and in the State of Florida with respect to what they are doing with retainage.

Mr. WATKINS. Yes, there has been a change over the past 2 years.

For example, in the city of Miami we are doing a convention center now. I have a contract for $1.9 million. There is no retainage until we are 75 percent complete. Then they will hold 5 percent for the last 25 percent of the job. That is the city of Miami.

Senator CHILES. It is 5 percent of the last 25 percent?

Mr. WATKINS. Yes, that is correct, Senator.

Senator CHILES. Have you ever been in such a cash flow crunch because of retainage that you had to borrow?

Mr. WATKINS. Yes, we have borrowed sporadically over the past year.

Senator CHILES. I suppose you paid a pretty good interest rate when you borrowed.

Mr. WATKINS. I believe that at the time the rate was only around 17 or 18 percent, something like that.

Senator CHILES. I noticed that—I would like to ask this of any of you. If the Government decides not to charge retainage of the prime contractors, why shouldn't the subs be relieved of it, too? Why is it sauce for the goose but not sauce for the gander?

Mr. JONES. I think they should be relieved, but I think that is just one more regulation in which you should not be involved.

If you tell the general contractor what kind of contract he must have with the subcontractors, I do not know what else you can tell him he has to do.

I am not opposed to the general contractor's eliminating retainage for his subs. I am opposed to the Government's telling him that he has to do it. I think this is a proper subject for negotiation between the general contractor and me.

Senator CHILES. We find ourselves in a situation with GSA, for example, where they have the authority to have less than 10 percent, but they do not do it. Would we find ourselves in the same situation, such that the primes would still be retaining everything from the subs?

Mr. JONES. That is a distinct possibility; namely, that the prime contractor will continue to withhold. I think that it would become incumbent upon the subcontractors and the subcontractors' association, some of whom have appeared before you today, to aggressively pursue equitable terms which would reflect the same kind of terms which the general contractor has with the owner.

What the general contractor now says is that they are withholding money from him, so he will not pay us the retainage. That provides a pretty good argument, whether you agree with it or not. It becomes a standard.

If it is removed, I think that we have every reason to believe that, in time, although maybe not immediately, we can negotiate similar terms with the general contractor, or he will not be able to get subs to work for him.

I am not opposed to the general having to pass the retainage on. I just think it is one more Federal regulation which we do not need.

Senator CHILES. I have a statement, Mr. Chairman, which I would like to have placed in the record.

I congratulate you on holding this hearing. I think that the merits of the bill are obvious.

Senator DANFORTH. Without objection, your statement will be inserted in the record at this point.

[Statement of Senator Chiles follows:]

OPENING STATEMENT OF SENATOR CHILES

S. 1782 seeks to assist small business firms by eliminating the practice of unreasonably imposing retainage or construction contracts. By retaining certain funds after contract completions, the Federal Government has cut into the cash flow of smaller, less affluent companies.

While it is true that the present recession has had a crushing effect on almost every sector of the American economy, the construction industry has been hit perhaps most severely of all.

The practice of withholding a percentage of a contractor's progress payments for 5 months or sometimes longer can have a detrimental effect on a contractor's cash flow. While I can certainly understand the rationale for the practice of retainage, we have heard so many horror stories concerning the length of time that retainages are held—after the job is completed.

When I conducted hearings on the Miller Act amendments in 1978, I was told that the twin plagues of the small business construction firm were bonding and cash flow problems. Well, we helped a little bit with the bonding problem through the enactment of the Miller Act amendments. We were able to make bonding requirements on smaller construction projects more reasonable. However, the larger cash flow problems stayed with the small construction contractors and became drastically worse.

When the practice of retainage began long ago, the procuring agency was dealing with a single general contractor who performed a majority of the work himself. The general contractor may have employed some craftsmen and tradesmen but they were on his immediate payroll. Perhaps because the work was performed on a single level, the practice of retainage worked. However, the process is vastly different today. Presently, a general contractor will subcontract a vast majority of work that he used to perform. The prime contractor now passes along his own retainage to the subcontractors, thereby significantly affecting cash flow at that level also.

Contractors and subs often find themselves in the marketplace borrowing money to cover those outstanding retainages. They are often forced to borrow at two and three percent above the prime rate. So, small companies find themselves in a situation where they must "forfeit" ten percent of the project cost, borrow to start another project, and hope through it all to have enough cash to see that project through. With interest rates so high, neither the owner, the prime contractor nor first subcontractor is eager to release the retainage until forced to do so. I am told that the nonpayment of retainage is one of the single largest causes for dispute on Government construction projects.

Second, and most importantly, retainage amounts to "double protection." This is, I think, the most persuasive agreement for its elimination, particularly when you weigh its costs. An American Subcontractors Association study shows that the average specialty contractor—usually a small businessman—is covering 200,000 dollars in outstanding retainages. When you consider that the subcontractor also had to post a performance bond to cover the work you ask whether the duplication is worth it. Why is it that both performance bonds and retainage are needed?

I think those who support retainage in today's world need to address themselves to the reasons for this "double protection."

I was a member of the Commission on Government Procurement and in its final report the Commission quoted a finding by the General Accounting Office which showed that a nine percent interest rate on 30 billion dollars worth of Federal contracts, retainage percentages could be costing Government construction procurement more than $30,700,000 per year or approximately $84,000 per calendar day. That was in 1970! All those figures have increased in the twelve years since the GAO findings. So if the Commission report was valid on retainage in 1970 it's certainly even more appropriate now.

I am a cosponsor of S. 1782 because I believe that giving statutory authority to a contracting officer to waive retainage when he believes work is proceeding efficiently and on schedule will help contractors. The bill would also eliminate the withholding of retainages from small business concerns provided the firm first posts an adequate performance bond.

This subcommittee has had a short but effective history in bringing about relief from burdensome regulations and Government redtape. The Paperwork Reduction Act and the Prompt Payment Act are but recent efforts that I am happy to have joined with the chairman, Senator Danforth, in achieving. Procurement reform may not be a sexy item; it may not grab the headlines but it is necessary if we are to achieve some sort of equitable relationship between Government and business in the marketplace.

Senator NUNN. On the last point, Senator Chiles, let me throw out one other point. This is something about which I have been concerned. I talked to Mr. Jones about it earlier today.

If we went one step further and said that the prime could not have any retainage from the subs, what would that do in terms of the prime contractor's willingness to contract with very small and minority businesses, which may be more marginal and have a higher risk of default? If we put the extra requirement on the contractor to the sub, would that make the prime contractor less willing to deal with smaller businesses and minority contractors or financially marginal subs?

Mr. JONES. I think that would introduce an element of jeopardy. It would bring on litigation. There would be some reluctance to do that.

On the contrary, you find some fine contractors who deal with small businesses or financially marginal subcontractors who pay them more frequently in order to get them to do the job.

I am an engineer, and I am proud of that, but engineers do not have much business training in engineering school, as you know, Senator. Much of my business expertise, to the extent that I have it, has been gained through hard knocks, by trial and error, and through some pretty bad experiences.

I think that, in general, the contracting industry is made up of economic illiterates and unsophisticates. We do not do a very good job of having an adequate return on our investments.

Particularly, the small single-ownership or just emerging businesses are marginal at best. I think that sometimes a general contractor will bring one along and be patronizing, if you will. He will pay them twice a month instead of monthly and help them to meet payrolls. This sort of thing would restrict his ability to do that. That is a practical matter.

I still contend to you that the principle is that the Federal Government should not do this. They ought not to interfere. I think, if you remove it from the general contractor, in time it will go to the private sector, and it will go to the subs, but it will take some effort on our parts.

Senator NUNN. Thank you.

I served in the legislature with Mr. Jones. I have known him for a long time. He is a good friend, and I am proud to have him here today. He is a neighbor of mine in middle Georgia, Mr. Chairman.

I want to join with Senator Chiles in congratulating you, Mr. Chairman, for holding this hearing. I am also a cosponsor of the bill. I do hope that we can move it.

Senator DANFORTH. Thank you.

We have a rollcall vote on the floor of the Senate now. I think we will take a break.

Let me ask you this, Mr. Jones. The only time I was in Macon, Ga., I was a boy. My father took me to the opening of the Purina Mill in Macon. Is it still there?

Mr. JONES. It is still there. It is about one-quarter of a mile up the road from our plant. I pass by it every day.

Senator DANFORTH. Eldon Cousin and Minnie Pearl were there for that.

Mr. JONES. They have not been there recently, but Purina is there. It is a good corporation, too.

Senator DANFORTH. I am glad to hear it.

Senator NUNN. When I became old enough to read, I read about that event. It had transpired 15 or 20 years before. [Laughter.]

Senator DANFORTH. We will recess for 15 or 20 minutes.

[Recess taken.]

Senator DANFORTH. You have been very patient, Mr. Cochran. Please proceed.

Mr. COCHRAN. Thank you very much, Mr. Chairman. I am Gordon Cochran of Cochran Electrical Service Co. in Seattle, Wash. I am also president of NECA [National Electrical Contractors Association] in Seattle, Wash. I am here representing the 6,500 members of NECA, who do approximately 60 percent of the contracted electrical work in the Nation.

I think that previous speakers have made it very clear that retainage has outgrown its usefulness. I agree with that.

In the past, a 10-percent retention was a good practice. On some contracts 5 percent was used. I heard GSA talk about a zero-percent retention. I have a comment with regard to that.

In 1978, I was very unfortunate in being a low bidder on an FAA job in Auburn, Wash. The general contractor's retention was zero percent. Upon receiving my subcontract, I noticed that I was to receive a 10-percent retention. I contacted him, and he said: "I am the general. I am zero. You are the sub. You are 10." Through my hard effort, negotiations, and good relationship with the general, I was able to negotiate 10 percent for halfway through and 5 percent thereafter. I felt very fortunate to get that because his answers and arguments were that if he gave in to me and gave me zero then he would have to give all of the other subcontractors on the project zero. He couldn't afford to do that because he needed the cash flow to take care of his cash flow.

One of the most disheartening things about the contract was that I did not receive my retainage until 11 months after I finished the job. For your information, that was the last Federal job I did.

I do approximately $20 million of work a year. My retention on private industry work right now is less than 10 percent of the projects which I am doing. The projects I am doing are mostly high-rise office buildings and complexes for private industry, such as Aetna Insurance, New York Life, Equitable Life, and other insurance companies.

They come to me as individuals and ask me how much money I am charging them for retention. My answer to them is anywhere from one-quarter percent to one-half percent to a full percent, depending upon how much retainage they have asked for. Their answer has been, and probably always will be: "Give me the cash and forget the retention."

The reason why is that I present a bill on the 25th of the month to the general contractor. The general contractor presents it with his bill to the owner on the 10th of the next month. He usually hands it to the owner on the same day. The owner appropriates the money from his lender. He then hands it back to the general. Usually, by the 20th of the month, I have my money which I can then present to the bank to pay bills. At that point, I am usually 20 to 25 days into the job with more payroll and more expenses for material, and I still have not received my first payment for the first 30 days.

If anyone is unhappy with my progress on the job at that time, that is the time for them to voice their complaint and stop my check.

I am not as fortunate as my predecessors in the area of profit. The electrical industry nationally is about 3 percent after taxes.

If a Government agency is holding a 10-percent retainage, that is a negative cash flow on a job. That makes it very undesirable for me to even do the job. It leaves me to become very evasive and to front-load the job to try to get money from the Government to fund my project.

In many cases the general contractor, who has some anticipation of problems on a project, can solve them by asking for a performance bond. Often a general contractor asks for a performance bond anyway and pays us for it. By asking all their major subcontractors to supply them with bonds, they can increase their bonding capacity by turning the bonds over to the bonding company.

The main thing which I want to emphasize is the cost savings to the Federal Government of at least, I estimate, 1 percent. The only way for them to incur the savings is if there is a flow-down process through the contract.

In the State of Washington, a law was passed 2 years ago which required on school projects that there be zero retention. The general contractors promised that if we did not have a flow-through process they would help us pass the bill. It was passed, and for 2 years none of the subcontractors received any of the flow-through. Last year we went back and rewrote the bill, passed it, and we now have a flow-through process.

If a flow-through process were included in this bill, the electrical contractors and I would look favorably on starting to do Federal work again.

Thank you.

Senator DANFORTH. Thank you. Your full statement will be included in the record.

Do you think that the Federal Government is more or less flexible than the rest of the country with respect to retainage policy?

Mr. COCHRAN. I consider them very inflexible.

Mr. JONES. I think that the Federal Government is much more inflexible in terms of times of payment, the method of payment, and the processing of it at the final draw. It is pretty rigid.

Senator DANFORTH. Do you agree with them, Mr. Watkins?

Mr. WATKINS. Yes, Senator, I agree 100 percent.

Senator DANFORTH. Does that make it less attractive to do business with the Federal Government?

Mr. WATKINS. Yes, it does.

Senator DANFORTH. In your view, does it reduce the amount of competition for jobs with the Federal Government?

Mr. COCHRAN. I believe it does.

Mr. JONES. Obviously, at this time most people in the contracting business are after any job they can get because we have an extremely depressed economy. Under normal conditions or in times when a contractor can show more discretion, many contractors will choose not to deal with the Government.

Mr. COCHRAN. At this time, Senator, some of my colleagues are looking to do Federal work because it is what is presently being done in the State of Washington. There is a lot of HUD work going on at this time. Many of them are unable to bid the work because they have eaten into their cash flow quite considerably over the last 12 months and do not have the cash flow to fund the projects.

Senator DANFORTH. Let me ask you one more question. It has to do with flow-down, which is, I think, the biggest single controversy with respect to this bill.

You made your position very clear, Mr. Jones.

Let us suppose that this bill did not have a flow-down provision for philosophical reasons or because of the concern expressed by Senator Nunn relative to minority subcontractors. Would the bill still be worthwhile from your point of view?

Mr. Jones says that it would. How about you, Mr. Watkins?

Mr. WATKINS. Subcontractors do, I would say, 75 percent of the work on any given average project. As one of the 75 percent, without a flow-down provision, I could not pass on any savings to you because I know that the general contractor will sit on the money.

Senator DANFORTH. You think that it is really not worth passing the bill unless we put it in.

Mr. WATKINS. I think that the flow-down aspect constitutes three-quarters of the work to be performed. It is mandatory for the Government to benefit from lower competitive bids and lower prices. Without the flow-down, you do not have them.

Senator DANFORTH. Some of the witnesses earlier indicated that if there were no flow-down mandated by the bill many general contractors still would pass on the no-retainage to the subs.

Mr. WATKINS. My experience is that the only time when the general contractor will do that is if you catch him. That is hard to do because he does not show you his contracts unless you put a tremendous amount of pressure on him. The average sub would never know the difference.

Senator DANFORTH. Have you a comment, Mr. Cochran?

Mr. COCHRAN. I believe you heard testimony from GSA that they did not see any dollar difference.

I was involved in one of those, as I told you. Until the general contractor has something in his hand at bid time which tells him that he has to pass through a no-retainage policy, I cannot pass the savings on.

Senator DANFORTH. You do not agree, Mr. Jones.

Mr. JONES. Most of the subcontracts with which I am familiar incorporate the provisions of the general contract between the owner and the general contractor. We refuse to sign a contract until we have a copy of that. We will not sign something unless we know what we are signing.

With all due respect, if other contractors or subcontractors sign a blank check, they will get what they deserve. You will not get it without asking for it. You will have more difficulty getting it from some general contractors than from others because you are now taking away his incentive. You are taking away his cash flow. He is putting this money in the bank and getting interest on it. I am sure he will give it up with a great deal of reluctance, but I think it can be negotiated. I think that is how it ought to be done.

Mr. COCHRAN. I would like to make a comment on the statement he just made. I did a job in which a general contractor withheld a retainage from the subs which was more than what he had retained. At the time when we finished the project, the general contractor would not finish one of his items so that we could get occupancy of the building. As subcontractors, we met with him and asked why he would not file for completion. His answer was that he had the money tied up in a CD [certificate of deposit], and he could not touch it for another 30 days to release it. Therefore, he did not want to finish the job.

The logic of what he was trying to do appalled me.

Senator DANFORTH. I think there are some problems with getting mandatory flow-down into the bill. It is not in the bill now. I think that it would run into a couple of types of argument in addition to the philosophical question: "We can govern our own contracts. We do not need the Government." It is a little difficult to move from that point of view to one of Government regulation of the prime-sub relationship, as Mr. Jones pointed out. Another point is the one which Senator Nunn raised relative to minority contractors and whether it would discourage general contractors from doing business with minority contractors if they could not have any retainage. I do not know. This is something to which we will have to give a lot of thought.

Thank you very much, gentlemen.

[The prepared statements of Mr. Jones and Mr. Cochran follow:]

STATEMENT OF

G. PAUL JONES, JR.

PRESIDENT, MACON PRESTRESSED CONCRETE COMPANY

ON BEHALF OF

PRESTRESSED CONCRETE INSTITUTE

HEARINGS BEFORE THE

SENATE GOVERNMENT AFFAIRS SUBCOMMITTEE ON

FEDERAL EXPENDITURES AND RULES

AUGUST 18, 1982

Mr. Chairman, members of the Subcommittee and Committee, my name is Paul Jones, President of Macon Prestressed Concrete Company in Macon, Georgia. I am here today representing the Prestressed Concrete Institute, a non-profit organization which consists of manufacturers, suppliers and design professionals. PCI's members are engaged in the production, placement and design of architecturally precast and structually prestressed concrete products. Nationwide, PCI's membership totals over 300 manufacturers, 77 suppliers and 1,500 professionals. I personally have served as President of this organization from 1975 through 1976 and I am currently Chairman of the Public Affairs Committee and member of the Advisory Council for the Prestressed Concrete Institute.

My testimony today will center on the effect of retainage on construction contract prices.

The tradition in the construction industry of withholding, or retaining, from the monies paid to the general contractor a portion of the estimated cost of the work performed as the project progresses is intended to ensure that the contractor will diligently and faithfully pursue the work on the project to completion in a timely manner and with anticipated quality of work performed. The retainage, held by the owner, was looked upon as an incentive to the contractor to complete the work with no undue delay and in substantial compliance with the contract documents.

Usually, 10% was retained from interim payments, with the net effect that, at the completion of the job, 90% had been paid to the general contractor and the remaining 10% retained would be paid upon acceptance by the owner. Throughout most of the history of construction in the United States interest rates were less than double digit and frequently in the 5%-6% range.

It was also traditional for the general contractor to withhold from his subcontractors, and infrequently from material suppliers, a similar retainage. This practice by the general contractors ensured that the bulk of the retainage was actually being withheld from the second tier of contractors and suppliers and that little, if any, retainage was actually being withheld from the general contractor's portion of the project. In recent years, a policy has sometimes been followed requiring the withholding of the traditional 10% retainage until the job is 50% complete, with no further retainage being withheld. This would mean that at the end of the project, only 5% was being withheld from the general contractor, but frequently the general contractor would continue to withhold 10% from all of his subcontractors. The net effect of this policy is that the general contractor was withholding more from his subs than was actually being withheld from the general contractor by the owner. Under these circumstances, the incentive that the retainage was supposed to provide became a disincentive. When the job was completed and the 5% retainage paid to the general contractor, the general contractor then had to pay out more than the 5% received to his various subs and material suppliers.

The onset of double digit interest rates, currently ranging between 15% and 20%, has created an oppressive burden on the construction industry, particularly the small subcontractors and material suppliers who have traditionally borne the brunt of the 10% retainage policy. This has resulted in increased construction costs due to heavy carrying charges included in sub bids, materials supply bids, and further marked up in the bid by the general contractor.

Recent suggestions by the Department of Defense and other agencies of government that retainage would not be withheld if the project is on schedule and if the contracting officer, in his discretion, concludes a project is being diligently pursued in the best interests of the government would appear to provide no jeopardy for the government and would appear to offer significant opportunities for reduction in costs by subcontractors and general contractors. This opportunity to the subcontractors would only be applicable if the general contractor in turn did not withhold retainage from their subs.

Frequently, it is the subcontractors performing their services at the beginning of a project who substantially finance the job by the retainage withheld from them. For example: a grading contractor, a foundation contractor, or the supplier of the structural prestressed concrete frame on a building will come on to the jobsite at the earliest stages. This work will be performed and completed and turned over to the general contractor to complete the project, but the retainage will be withheld until the job is completely finished, accepted by the owner, and retainage paid to the general contractor. Obviously, those performing grading, the foundations or piling or caissons or spread footings, or those supplying and erecting the prestressed concrete structural frame will all complete their work in the first few months of the project. Frequently, all of this work is performed in the first 20%-25% of the construction time. Yet, 10% of subcontract prices are retained until the project is completed, during which time none of these personnel normally have any reason whatsoever to perform any work or services or supply any materials to the jobsite. Frequently, the period retainage is withheld is six, twelve, eighteen months or more, for construction work performed in 3-4 months at the beginning of a job.

Therefore, should the policy of eliminating retainages be implemented, for the government to get the full effect of any cost reductions by the various trades or tiers or contracting work performed, provision must be made for inspections to be performed on an interim basis and for the payment to be made in full to those trades that have performed and completed their work. If some portion of the work cannot be performed until the structure is nearing completion, that portion could be withheld pending the performance of the work required. However, to withhold retainage for a period of months or even years simply because the general contractor had not completed the entire project is unjustly penalizing the second tier contractors and suppliers and compelling them to add significant carrying charges for the funds being retained from their contracts.

Critics of this proposal claim that abolishing the traditional practice of retainage will remove some of the protection needed by the owner to ensure that the contract is completed in a timely manner and in accordance with the specifications.

Most government contracts are bonded, and the protection is there to complete the contract if the general contractor defaults. The surety bonding industry obviously does not want to take on additional responsibility in this matter, but adequate supervision by the supervising professionals to ensure that only work performed is actually paid for and to ensure that specifications are being met and in a timely manner would appear to provide adequate protection for the government. Further, the provision that retainage can be withheld if the job falls behind schedule would be a significant incentive to the general contractor to keep the job on schedule and to do everything possible to ensure that his particular contract is not subject to retainage.

Another criticism suggests that this elimination of retainage between the owner and the general contractor will not require the general contractors similarly to abolish retainage to their subs and that the subcontractors will continue to finance the project for the general contractor through their retainage. Most retainage clauses in subcontracts refer to the retainage provision in the general contract with the owner, and elimination of this clause would be a major help to the subcontractors to negotiate favorable terms with the general contractor eliminating retainage, or at the very least requiring that retainage be paid in full within a reasonable time, say thirty days after the subcontractor's portion of the work is completed. Admittedly, this will take considerable work and effort on the part of subcontractors and subcontractors associations to change what has become a tradition in the construction industry. However, such efforts will be greatly assisted if the general contracts with the owner recognize that retainage simply adds to the cost of the project and that adequate protection to the owner (or to the general contractor with his subs) is provided by bonds, better inspection, etc.

The suggestion has been made that the general contractor be prohibited from withholding retainage from his subcontractors. I do not believe this is a good provision, and we do not support it. There is no reason for the government to dictate terms between the general contractor and his subs. Rather, if the general contractor feels that he must withhold retainage to a specific subcontractor, he must evaluate that situation as contrasted with another subcontractor, with a different price and who will not negotiate a retainage clause in a subcontract. This would provide more competition in an already highly competitive construction market and would ensure that the lowest responsible price is considered and is available to the general contractor and ultimately to the owner.

In summary, in today's economy the cost of financing retainage for the entire life of the project is adding considerably to the total construction costs to the owner. Elimination of the retainage provisions will offer opportunities for significant cost reductions to the owner.

Much of the cost of financing this retainage of funds is borne by the subcontractors and material suppliers. Frequently, at the completion of a project and before the retainage is paid to the general contractor, the general contractor has more retained from his subs and material suppliers than the owner has retained from the general contractor. This means that the cost of financing this retainage is borne by the second tier contractors and suppliers, many of whom are sole owners or small business concerns, some of which perform their services at the very beginning of a project but have funds retained for the entire life of the project.

In order to provide the maximum opportunity for cost reductions, provisions must be made that more frequent inspections be required so that those portions of the work that are completed in the early part of the project can be inspected and approved and accepted and paid for completely.

There should be no effort to require the general contractors to have any specific retainage agreements with his subcontractors, but elimination of the retainage provision in the contract between the general contractor and the owner will provide a vehicle for similar clauses to be in the subcontracts between the general contractor and his subs.

The existence of a performance bond by the general contractor to the owner, or by various subcontractors to the general, provides adequate protection that the job will be completed in accordance with the specifications. A better quality of inspection and more frequent inspections will give the contracting officer firmer control of the project and allow the contracting officer to withhold retainage if the job is not on schedule or not being pursued in accordance with the specifications. This discretionary judgment could be applied to work performed by the general contractor, or it could involve only work performed by a specific subcontractor.

BIOGRAPHICAL DATA

G. Paul Jones, Jr., President
Macon Prestressed Concrete Company
Macon, Georgia

Professional, Community, Political, and Academic Positions:

Chairman of Public Affairs Committee and member of Advisory Council of Prestressed Concrete Institute, and Past President of this national organization (1975-76).

Chairman, Policy Committee of National Construction Industry Council (NCIC) and former vice chairman of this national organization.

Division Leader, United Way of Bibb County, Building and Construction Division (1982).

Member, National Advisory Council for Georgia Institute of Technology. Now serving second four-year term on this national body.

Member of Rotary Club, Phi Delta Theta Fraternity, Tech-Georgia Development Fund.

Former member YPO (Young Presidents' Organization). Now member of Presidents' Forum.

Past Chairman, Republican Party of Georgia (1965-1969).

Past State Representative, Georgia General Assembly. Represented Bibb County for two terms (1965-66).

Past Director, Greater Macon Chamber of Commerce and served as Chairman of Industry Committee.

Education and military record:

Graduated from Lanier High School, Macon, Georgia, in 1948 holding the rank of Lt. Colonel in Lanier ROTC Program.

Graduated from Georgia Institute of Technology in 1952 with a Bachelor Degree in Mechanical Engineering.

Commissioned Captain in U. S. Army Reserve. Served in Korea with U. S. Army Corps of Engineers (1952-54).

Work Experience:

Employed by Cornell-Young Company after receiving honorable discharge from U. S. Army Reserve. In 1956 he assisted in forming Macon Prestressed Concrete Company, a manufacturer of precast/prestressed concrete products. Now serves as President of MPC and Vice President of Cornell-Young Company.

Church Affiliation:

Member of First Presbyterian Church, and presently serving as Ruling Elder and member of the Session. Previously member of Deacons and served as Chairman of Deacons.

Member, Board of Trustees of Covenant Theological Seminary.

Personal:

Born in Florence, South Carolina, June 28, 1930. Soon thereafter moved to Macon, Georgia with his parents.

Married Miss Dallis Johnson of LaGrange, Georgia, in 1955. They have three children: G. Paul Jones, III, Mary Sanford Jones, and Louise Hollis Jones.

July 1982

Statement of Gordon Cochran
Cochran Electrical Service Company
Seattle, Washington
before the
Subcommittee on Federal Expenditures, Research and Rules
of the
Senate Governmental Affairs Committee
in regard to

S. 1782, a bill for Elimination of Retainage in Certain Instances

Chairman Danforth, Members of the Committee, thank you for allowing me this opportunity to appear before you today to express my strong support for S. 1782, Senator Weicker's bill to eliminate retainage on Federal construction contracts where the job is proceeding satisfactorily and to eliminate it from contracts with small business in all instances.

As you know, my name is Gordon Cochran. I am an electrical contractor from Seattle, Washington, and a member of the National Electrical Contractors Association - an organization of over 6,500 member firms which do nearly 60 percent of the nation's electrical construction. NECA and its members join me in my strong support for the legislation being considered here today.

Retainage, especially on Federal contracts, is a practice which has outlived its usefulness. The practice of withholding a portion of a contractor's progress payments in order to assure satisfactory completion of a construction job grew up many years ago in an environment totally different from that we face today. It was originated in days of low interest rates, by private developers who felt the need for some measure of protection. The history of retainage shows that, in some times, it may have amounted to as much as twenty percent or more of a progress payment.

However, as construction has increased in professionalism, as the costs of the practice have risen - due to increasing financing costs, and as the need for the protection retainage once may have provided has decreased, the retainage rate has dropped as well. Ten years ago the average rate of retainage was about 10%. Today it is closer to five percent. In some areas a practice has grown up where retained funds are escrowed, with interest paid to the contractor who is due the money.

In Federal work, today, the practice of retainage is doubly outmoded. Not only does the Federal government have fully adequate safeguards for getting a construction project completed on time and in a satisfactory manner, but the practice has pernicious side effects as well.

First, the safeguards:

- Before a progress payment is made for any portion of the work done, a government contracting officer or his agent must certify that the work has been completed and is satisfactory. Thus, a contractor is not getting money which has not been earned. Out of this progress payment he must pay for materials installed and labor performed, as well as his overhead costs. If a retainage is withheld, the money to pay these expenses must be made up through funds borrowed from commercial lending institutions at market rates.
- The government requires a performance bond to assure completion of the job. This bond is already an extra measure of protection.
- The government may withhold final payment on the job, which in itself can often total ten percent of the total job cost, until the job is complete and satisfactory.

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- As a final protection, even after the job is complete, the government will have a warranty on the work for at least a year in most cases.

Second, the pernicious effects:

- The practice is costing the government money. In 1975 the General Accounting Office noted, in its study on bonding, that elimination of retainage could save the Federal government money. That is even more true today. Money retained from progress payments must be borrowed at market rates. Any competent contractor must include that cost in his bid. Eliminate the retainage and that cost is eliminated...the government saves the money.

- The number of qualified contractors who will bid Federal jobs is reduced. The problems and red tape associated with Federal construction, generally, are compounded by the practice of withholding retainage. Further, a contractor who may be quite capable of handling the construction chores, simply may not have the capability to finance the retainage at today's steep interest rates. The government loses and the contractor loses.

I have stated that I and the electrical construction industry in general support this measure. However, there are a couple of changes which would make it even more effective.

Since the government, because of the safeguards which already exist, does not generally need to withhold retainage, the bill should be written in that way. In other words, the contracting officer should have to make a case for the circumstances necessitating withholding of retainage if it is to be withheld. The presumption must be that there will be no retainage.

Second, on Federal construction contracts today prime contractors are required to pass on contract conditions to their subcontractors in many instances. These cover all aspects of the work. A Federal prime contractor with the GSA must pass on in his subcontracts, Federal requirements regarding:

- Equal Employment Opportunity and Affirmative Action
- Disabled and Vietnam Era Veteran Utilization
- Employment of the Handicapped
- Audit and Inspection
- Subcontracting Cost and Pricing Data
- Non-Defense Contract Cost Accounting Standards
- "Buy American" provisions
- Davis-Bacon rules

These are all part of the standard GSA General Conditions of Contract.

I believe, and NECA also supports the concept, that the same provisions for elimination of retainage which affect a prime Federal contractor under this legislation should flow down to the subcontracts as well.

We urge you to make these minor amendments to the legislation and to move it toward passage as soon as possible. Thank you for allowing me this opportunity to testify before you.

Senator DANFORTH. The next witnesses are Harold Rhyne and Michael Callas.

Please proceed, Mr. Rhyne.

TESTIMONY OF HAROLD RHYNE, OWNER, RHYNE ELECTRICAL CONTRACTORS, ON BEHALF OF THE INDEPENDENT ELECTRICAL CONTRACTORS, INC.

Mr. RHYNE. Mr. Chairman, thank you and the other members for inviting us here today. My name is Harold Rhyne. I am the owner of Rhyne Electrical Contractors in Atlanta, Ga.

Like some of the other contractors, our work over the past 6 years has been primarily with government agencies—State, local, and Federal. We have worked for the FAA, the Corps of Engineers, the Air Force, Navy, the Department of the Interior, HUD, and numerous other Federal agencies.

We are discouraged to some extent by the amount of regulation through which we have to go. At the same time, we build the cost of these expenses into our bids. Also, other than the normal items which we do in our commercial work in the private sector, we hold more stringently to contract requirements in Federal projects. Any area of vagueness is pursued to the fullest extent, and we do not give the leeway which we would normally give in commercial projects. Some of this is because of the retainage issue.

I am here today on behalf of the Independent Electrical Contractors [IEC], a nationwide trade association. Eighty percent of construction work is done on the merit shop basis. In addition to IEC's regular members, I am also speaking today on behalf of several thousand electrical contractors affiliated with IEC on this most important issue.

IEC appreciates the opportunity to present its views and those of its affiliated groups and wishes to enter our extended written comments into the official committee record.

Mr. Chairman, any remarks on the troubled conditions in the construction industry are redundant. What is important to you and your colleagues in the Senate and House is that now there is something to do to help the situation. S. 1782, which seeks to amend the Federal Property and Administrative Services Act, is a first step toward helping to reduce the cost of Federal construction, encouraging more contractors to get involved in Federal work, and giving hard-pressed small business a better chance to survive through increased financial stability. Retainage of payments on Federal projects causes hardships for small contractors who make up the majority of Federal construction project firms.

In addition to the obvious financial management problems, retainage often results in delays of project completion and a waste of Government funds. As you have heard previously, the practice of withholding payments for work performed on Federal construction projects is an outdated and needless tradition. The standard requirement for contractors to have bonding for the full amount of the projects assures the Government of receiving what it pays for. With this protection assured, it is not only reasonable but in fact good business for the Government to pay fully for work performed.

This Congress and this administration have shown a desire to reduce unnecessary costs and bring a businesslike manner to Federal dealings with private contractors. The passage of the Prompt Payment Act and, hopefully soon, the implemented changes in the Davis-Bacon Act are not just stopgap measures. They are among the steps necessary to give the American taxpayer what he deserves from his Government.

The thousands of electrical contractors whom I represent here today through IEC believe strongly that S. 1782 is another positive step in the right direction.

I would like now to give two personal experiences on Federal projects which we have completed over the past year.

One was a project at Fort Stewart which is in Savannah, Ga. It was a spray irrigation project that involved our going in and running pole lines, which means overhead distribution, in the initial phase of an 18-month job. We completed 80 percent of our total contract in the first 45 days, and 10 percent of the project was withheld throughout the course of the 18 months.

On a $45,000 contract, we expanded our bid by $3,800 to pay for the increased cost of financing the Federal Government on the project.

We are also doing a readiness contract for the U.S. Air Force and Corps of Engineers at Fort Bragg in Fayetteville, N.C., which is in excess of $1 million. We expanded our bid by $72,000 to cover the cost of financing the Federal Government over a 2½-year project.

Thank you.

Senator Danforth. Thank you very much. Without objection, your complete statement will be inserted in the record at this point.

[The prepared statement of Harold Rhyne follows:]

INDEPENDENT ELECTRICAL CONTRACTORS INC.
1101 Connecticut Avenue • Suite 700 • Washington, D.C. 20036 (202) 857-1141

STATEMENT OF
HAROLD RHYNE
OWNER, RHYNE ELECTRICAL CONTRACTORS, ATLANTA GEORGIA
ON BEHALF OF THE
INDEPENDENT ELECTRICAL CONTRACTORS, INC.
AND ITS SUPPORTING ASSOCIATIONS
BEFORE THE
SUBCOMMITTEE ON FEDERAL EXPENDITURES,
RESEARCH, AND RULES
OF THE
SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS
AUGUST 18, 1982

The following statement is made on behalf of the Independent Electrical Contractors, Inc. (IEC). IEC is a nationwide association made up of individuals and chapters who participate in the electrical construction field. In addition to the regular members of IEC these statements are also presented on behalf of the attached list of affiliated electrical contractor groups that operate on a state and local basis throughout the United States.

The following statements are made in support of Senate bill 1782 "The Small Business Contract Payment Procedures Act" which was introduced by Senator Weicker on October the 14th, 1981. This bill seeks to amend or discontinue the current practice of retainage of funds on federal projects. Retainage is a practice of holding back a stated amount, usually about 10%, from each payment that is given to a contractor at the completion of a certain percentage of work or at the end of an entire project. This practice, in effect, means that subcontractors or contractors of federal construction projects receive somewhere in the vicinity of only 90% of the agreed-upon price for work performed. This practice has been in effect for many years on federal construction projects and it is the opinion of this association, and the others that it represents, that the practice is no longer necessary or economically feasible on these federal construction projects.

In the past the government has listed several reasons why retainage was traditionally withheld from contract payments. These reasons included the desire to discourage financial irresponsibility for the part of contractors, THE INTEREST OF SAVING THE OWNER THE COST OF INTEREST ON AMOUNTS OF MONIES THAT WERE PAID OUT, SOME WAY OF PROVIDING SOME TYPE OF FINANCIAL STABILITY FOR THE OWNER IF THE WORK WAS NOT COMPLETED ON TIME AND ACCORDING TO CONTRACT, AND TO PROVIDE SOME LEVERAGE FOR THE CONTRACTOR IN THE EVENT THAT THE CONTRACT IS NOT FULLY PERFORMED. WHILE THESE REASONS MAY HAVE BEEN VALID MANY YEARS AGO, IT IS THE BELIEF OF IEC AND ITS AFFILIATED GROUPS THAT THESE REASONS ARE NOT ONLY OUTDATED BUT IN EFFECT HAVE BECOME A BURDEN ON THE TAXPAYING PUBLIC. FURTHERMORE, WHILE THIS ADMINISTRATION HAS ATTEMPTED TO RUN ITS AFFAIRS IN A MORE BUSINESSLIKE MANNER IN MANY AREAS, IT HAS NOT KEPT PACE WITH THE PRACTICES OF PRIVATE BUSINESS WHICH NOW CALL FOR LESS THAN THE STANDARD 10% RETENTION HELD ON FEDERAL PROJECTS. IEC WOULD LIKE TO ADDRESS THE SPECIFIC POSITIVE AND NEGATIVE AREAS OF RETAINAGE ONE BY ONE, AND POINT OUT THE MAIN REASONS THAT IT AND ITS AFFILIATED GROUPS FEEL THAT THE PRACTICE OF RETAINAGE ON FEDERAL PROJECTS IS NO LONGER NECESSARY.

FINANCIAL CONSIDERATIONS

PERHAPS THE EASIEST AREA TO RECOGNIZE IN THE RETAINAGE QUESTION IS THE AREA OF FINANCIAL PROBLEMS THAT RETAINAGE CREATES FOR CONTRACTORS AND FOR THE GOVERNMENT. THE FIRST AREA THAT IS AFFECTED BY THE RETAINAGE ISSUE IS THE AREA OF LESS COMPETITION FOR FEDERAL PROJECTS. MANY SMALL CONTRACTORS, KNOWING THAT THEY WILL HAVE TO ACCEPT LESS THAN FULL PAYMENT FOR COMPLETED WORK FROM THE GOVERNMENT, DON'T BID ON FEDERAL PROJECTS AT ALL. WITH FEWER BIDDERS ON FEDERAL JOBS, THE FEDERAL TAXPAYER IS LIKELY TO GET LESS OPPORTUNITY TO GET A FULL DOLLAR'S WORTH OF CONSTRUCTION FOR HIS FEDERAL TAX DOLLAR. KNOWING THAT THEY WILL HAVE TO BORROW MONEY IN ORDER TO MAKE UP THE DIFFERENCE BETWEEN WHAT THEY HAVE TO PUT OUT AND WHAT THEY WILL GET PAID IN RETURN FOR THEIR WORK, CONTRACTORS DO NOT VIEW FEDERAL WORK AS A GOOD PROS-

PECT IN MANY AREAS. THE ELIMINATION OF RETAINAGE COULD CHANGE THIS.

THE SECOND AREA OF FINANCIAL CONSIDERATION THAT MUST BE ADDRESSED IS THAT OF WHAT COSTS ARE PASSED ALONG TO THE FEDERAL GOVERNMENT IN ADDITION TO THE NORMAL COSTS OF DOING BUSINESS. RATHER THAN ACTUALLY LOOKING AT THE AMOUNT OF MONEY RETAINED FROM FEDERAL CONSTRUCTION PAYMENTS AS AN ADDITIONAL SOURCE OF INCOME AND INTEREST-GENERATING FUNDS FOR THE FEDERAL GOVERNMENT, THE PRACTICE OF RETAINAGE MUST ACTUALLY BE VIEWED AS A DRAIN ON THE FEDERAL GOVERNMENT. KNOWING THAT THEY WILL BE PAID LESS THAN THE FULL VALUE FOR THEIR COMPLETED CONSTRUCTION WORK, BIDDERS ON FEDERAL CONSTRUCTION PROJECTS ARE FORCED TO INCREASE THEIR REGULAR BID PRICE FOR FEDERAL WORK. THEY KNOW THAT THEY WILL HAVE TO HAVE ENOUGH MONEY TO PAY CURRENT EXPENSES REGARDLESS OF THE ACTUAL COST OF THE JOB. IN ADDITION, CONSTRUCTION COMPANIES DEPEND HEAVILY UPON THE ABILITY TO GENERATE LARGE AMOUNTS OF CASH ON A SHORT TERM BASIS IN ORDER TO PAY FOR EQUIPMENT AND LABOR. BY CUTTING DOWN THE AMOUNT OF CASH FLOW AVAILABLE TO A CONTRACTOR, THE PRACTICE OF RETAINAGE ACTUALLY MAKES IT NECESSARY FOR CONTRACTORS TO GENERATE ADDITIONAL SOURCES OF INCOME EITHER THROUGH INCREASED PRICES OR THE NON-PURCHASE OF ESSENTIAL EQUIPMENT. SO IN ADDITION TO THE OBVIOUS COSTS OF FEWER BIDDERS ON CONSTRUCTION PROJECTS, THE PRACTICE OF RETAINAGE ENCOURAGES THOSE BIDS THAT ARE SUBMITTED TO BE HIGHER THAN NECESSARY.

ANOTHER ASPECT OF THE RETAINAGE ISSUE THAT REFLECTS ON THE FINANCIAL POSITION OF BOTH CONTRACTOR AND THE GOVERNMENT IS THE FACT THAT MANY SUBCONTRACTORS ON A CONSTRUCTION PROJECT FINISH THEIR WORK AT DIFFERENT TIMES. THEREFORE, A CONTRACTOR WHO IS INVOLVED WITH THE BEGINNING PROCESSES SUCH AS FOUNDATION WORK MAY HAVE TO WAIT UNTIL AN ENTIRE PROJECT IS COMPLETED BEFORE HE RECEIVES PAYMENT FOR HIS WORK. THIS INCREASED LENGTH OF TIME WITH-

OUT THE USE OF THESE FUNDS ADDS TO THE ADDITIONAL COST TO THE GOVERNMENT BECAUSE THE INCREASED LOSS OF REVENUE MUST BE PASSED ALONG TO THE GOVERNMENT IN THE BIDS FROM THESE CONTRACTORS.

THE FINAL FINANCIAL ASPECT OF THE RETAINAGE ISSUE THAT MUST BE ADDRESSED IS THE REDUCED OPERATING CAPITAL AVAILABLE TO CONTRACTORS FOR THE EXPANSION OF THEIR BUSINESSES. A GREAT DEAL OF THE FEDERAL GOVERNMENT'S ECONOMIC RECOVERY PROGRAM IS DEPENDENT UPON THE REINVESTMENT OF CAPITAL INTO COMPANIES THAT CAN PRODUCE JOBS AND EQUIPMENT TO REVITALIZE OUR ECONOMY. THE PRACTICE OF RETAINAGE NOT ONLY HAMPERS THIS, BUT IN FACT ACTUALLY DISCOURAGES CONTRACTORS FROM REINVESTING IN IMPROVEMENTS IN THEIR OPERATIONS. WITHOUT KNOWING EXACTLY WHEN OR HOW MUCH OF THEIR COSTS CAN BE RECOVERED THROUGH PAYMENTS BY THE GOVERNMENT FOR WORK PERFORMED, FEDERAL CONTRACTORS, AND SPECIFICALLY THOSE THAT ARE SMALL BUSINESSES WITH SMALL OPERATING MARGINS TO BEGIN WITH, DON'T HAVE ANY INCENTIVE TO REINVEST IN THEIR OWN COMPANIES. THIS PRACTICE HAS CAUSED BANKRUPTCIES, JOB LAY-OFFS, AND ECONOMIC HARDSHIPS IN MANY OTHER INDUSTRIES AND IN MUCH OF THE CONSTRUCTION INDUSTRY IN THE PAST TWO YEARS. THE ELIMINATION OF RETAINAGE THROUGH THE IMPLEMENTATION OF SENATE BILL 1782 WOULD AT LEAST HELP TO GENERATE REINVESTMENT IN CONSTRUCTION EQUIPMENT AND JOBS. THE ELIMINATION OF RETAINAGE WOULD PROBABLY SAVE BILLIONS OF DOLLARS TO FEDERAL CONTRACTORS WHO COULD THEN CREATE NEW JOBS AND REINVEST IN BETTER EQUIPMENT WITH THE MONEY SAVED.

IN SUMMARY THEN, THE FOUR FINANCIAL AREAS THAT ARE AFFECTED BY THE CONTINUED PRACTICE OF RETAINAGE ARE: FEWER BIDDERS ON FEDERAL CONSTRUCTION PROJECTS, HIGHER BIDS FROM THOSE CONTRACTORS WHO DO FEDERAL WORK, A LESSENING CASH FLOW FLEXIBILITY FOR FEDERAL CONTRACTORS, AND REDUCTION IN THE AMOUNT OF

MONEY AVAILABLE TO REINVEST IN NEW JOBS AND NEW EQUIPMENT FOR FEDERAL CONTRACTORS.

NON-FINANCIAL CONSIDERATIONS

IN ADDITION TO THE AFOREMENTIONED FINANCIAL HARDSHIPS CAUSED ON BOTH THE FEDERAL GOVERNMENT AND CONTRACTORS BY THE CONTINUED PRACTICE OF RETAINAGE, THERE ARE SEVERAL AREAS OF THE ISSUE THAT DO NOT DIRECTLY AFFECT FINANCE YET HAVE AN INDIRECT BEARING ON THE VALUE OF THE CONSTRUCTION DOLLAR FOR THE FEDERAL TAXPAYER. FIRST AMONG THESE IS THE MISGUIDED CONCEPTION THAT THE PRACTICE OF RETAINAGE WILL ASSURE PERFORMANCE ON A SATISFACTORY BASIS. SINCE THE MILLER ACT DOES REQUIRE FEDERAL CONTRACTORS TO PROVIDE PERFORMANCE BONDS IN SUCH AN AMOUNT AS DEEMED APPROPRIATE BY THE CONTRACTING AGENCY, IT IS UNNECESSARY TO CONTINUE THE PRACTICE OF RETAINAGE TO ASSURE PERFORMANCE ON CONSTRUCTION PROJECTS. THE PERFORMANCE BOND IS USUALLY SET AT 100% OF THE CONTRACT PRICE AND DOES PROVIDE THE FEDERAL GOVERNMENT WITH A GUARANTEE OF FULL PERFORMANCE. IT ALSO HELPS TO ELIMINATE THE BIDDING OF FEDERAL WORK BY THOSE CONTRACTORS WHO ARE NOT IN THE POSITION TO COMPLETE THE WORK SINCE THEY WILL NOT BE ABLE TO OBTAIN THE NECESSARY BONDING. THEREFORE, THE ARGUMENT THAT RETAINAGE IS NECESSARY TO ASSURE COMPLETION OF FEDERAL PROJECTS NO LONGER IS EFFECTIVE.

THE SECOND NON-FINANCIAL CONSIDERATION IS THE EFFECT THAT RETAINAGE HAS ON THE ALREADY STRAINED RELATIONSHIPS BETWEEN GENERAL CONTRACTORS AND SUBCONTRACTORS ON CONSTRUCTION PROJECTS. WHETHER OR NOT IT IS A REASONABLE ASSUMPTION, THE SUBCONTRACTOR IS OFTEN LED TO BELIEVE THAT GENERAL CONTRACTORS WHO WITHHOLD PROGRESS PAYMENTS FOR WORK COMPLETED ARE, IN EFFECT, USING MONIES WHICH RIGHTFULLY BELONG TO THE SUBCONTRACTOR FOR THEIR OWN PURPOSES. THIS WORKS TO CREATE A MORE ADVERSARIAL RELATIONSHIP BETWEEN GENERAL CON-

TRACTORS AND SUBCONTRACTORS THAN IS NORMAL OR NECESSARY. A GOOD CONSTRUCTION PROJECT COMPLETED ON TIME AND WITHIN BUDGET IS DEPENDENT UPON A TEAMWORK ATMOSPHERE AMONG THE GENERALS AND SUBCONTRACTORS ON THE PROJECTS. THE PRACTICE OF RETAINAGE STANDS IN THE WAY OF CREATING A MORE COOPERATIVE JOBSITE. IT ALSO WORKS TO THE DISADVANTAGE OF THE GOVERNMENT AGENCY WHO IS USING RETAINAGE AS A MEANS OF CREATING UNNEEDED LEVERAGE FOR ITSELF.

THE THIRD NON-FINANCIAL ASPECT OF THE RETAINAGE ISSUE IS THAT OF CONSTRUCTION DELAYS. ALTHOUGH RETAINAGE HAS FREQUENTLY BEEN USED AS A METHOD FOR ASSURING PROMPT COMPLETION OF FEDERAL PROJECTS, THE OPPOSITE IS QUITE OFTEN THE CASE. WHEN A CONTRACTOR KNOWS THAT HE IS UNLIKELY TO RECEIVE FULL PAYMENT FOR PERFORMANCE ON A FEDERAL CONSTRUCTION PROJECT AS IT IS COMPLETED, THERE IS NO MOTIVATION FOR HIM TO COMPLETE THE PROJECT ON TIME AS CALLED FOR IN THE CONTRACT. THIS IS COMPOUNDED BY THE FACT THAT SOME SUBCONTRACTORS ON CONSTRUCTION PROJECTS KNOW FULL WELL THAT THEY WILL NOT BE PAID UNTIL THE END OF THE ENTIRE PROJECT, AND IN EFFECT, HIS PAYMENT IS BASED UPON THE WORK PROGRESS OF OTHER SUBCONTRACTORS ON THE JOB. THEREFORE THE PRACTICE OF RETAINAGE DOES NOT ENCOURAGE AN INDIVIDUAL SUBCONTRACTOR TO COMPLETE HIS WORK ANY FASTER THAN NECESSARY DUE TO THE FACT THAT PAYMENT WILL BE WITHHELD UNTIL ALL SUBCONTRACTORS ON A JOB HAVE FINISHED THEIR WORK.

TO SUMMARIZE THE NON-FINANCIAL ASPECTS OF THE RETAINAGE ISSUE THE FOLLOWING AREAS NEED TO BE RE-EMPHASIZED: RETAINAGE DOES NOT ASSURE PERFORMANCE UNDER TERMS OF A CONTRACT ON FEDERAL PROJECTS; IT DOES CREATE PROBLEMS IN THE RELATIONSHIPS BETWEEN GENERAL AND SUBCONTRACTORS ON A FEDERAL JOB; AND RETAINAGE DOES NOT ELIMINATE THE PROBLEM OF CONSTRUCTION DELAYS AND, IN FACT, MAY HELP TO CREATE MORE DELAYS THAN ARE NECESSARY.

Summarization of IEC Views on Retainage

The Independent Electrical Contractors represents thousands of small to medium-sized construction firms in the electrical trade, many of whom participate in federal construction projects at this time. It is the belief of IEC and those groups who support IEC on the retainage issue, that when the federal government withholds payments through their practice of retainage the increased costs that are sustained by the contractor must be passed along to the federal government in one form or another. It is the elimination of these increased costs that is the main goal of Senate bill 1782 and is the program supported by our group. The elimination of retainage would, in our opinion, result in more bidders on federal construction projects who would submit lower bids, allow for a better cash flow position in the many small businesses that participate in federal construction work, and would allow these companies to reinvest more operating funds in machinery and jobs to help revitalize the economy. Additionally, the elimination of retainage would not affect the performance of federal contractors, it would help lessen the strained relationships between general and subcontractors on jobs, and would cause no unnecessary delays on the completion of federal work.

The Independent Electrical Contractors and the affiliated groups listed below sincerely hope that the Congress will enact Senate Bill 1782, and its companion bill H.R. 5022, jointly known as "The Small Business Contract Payment Procedures Act". The implementation of these programs would basically eliminate retainage on federal construction projects and assist the many small businesses in the construction field who participate in federal work. The ailing construction industry desperately needs assistance not in the form of federal hand-outs, but in the form of reduced Federal burdens on small businesses. The Independent Electrical Contractors, and its supporting organizations, appreciate this opportunity to express their views to the Congress of the United States and stand ready to add any additional information necessary to enable the Senate to enact Senate bill 1782.

Associations supporting the Independent Electrical Contractors, Inc. position on S. 1782 include:

Arizona Independent Electrical Contractors Association

Connecticut Electrical Contractors Association

Independent Electrical Contractors Association of Philadelphia

Massachusetts Electrical Contractors Association, Inc.

Minnesota Electrical Association, Inc.

Washington State Electrical Contractors Association, Inc.

Senator DANFORTH. Mr. Callas.

TESTIMONY OF MICHAEL CALLAS, PRESIDENT, CALLAS CONTRACTORS, INC., ON BEHALF OF THE ASSOCIATED BUILDERS & CONTRACTORS, INC.

Mr. CALLAS. Good morning, Mr. Chairman. I am Michael Callas, president of Callas Contractors, Inc. We are a general building construction firm located in Hagerstown, Md. I am also a member of and representing the Associated Builders & Contractors, Inc. [ABC], a national construction trade association with nearly 17,000 member firms, employing more than 1 million construction workers throughout the United States. The members of ABC believe in the "merit shop" philosophy, a concept which calls for open competitive bidding with contract award to the lowest bidder. Today, more than 60 percent of all construction in this country is done the merit, or open, shop way. Furthermore, ABC supports S. 1782, the Small Business Contract Payment Procedures Act, which states that Federal contracting officers cannot withhold retainage from progress payments if the work is satisfactory or if the firm is a small business which has posted a performance bond.

I thank the committee for the opportunity to testify on the subject of retainage and its impact on the small business construction companies and related industries of our country.

A company performing a contract for an agency of the Federal Government will bill the Government, usually at the end of each month, for the value of work it has completed during the preceding month. The Federal Government's policy is to withhold a certain percentage of the amount of money due the contractor, usually 10 percent, for work that the contractor has already performed. This amount of money withheld is referred to as retainage; that is, held back or retained by the Federal Government supposedly to insure satisfactory completion of all the required contractual work. At least, this was the purpose of the retainage policy when it was devised some years ago.

Today, retaining a portion of a contractor's payments to insure adequate performance is duplicative of other standard procedures in our industry. For years now contractors and subcontractors have been required to furnish the Government agencies with performance bonds, issued by reputable surety companies, guaranteeing completion of their contractual work. So today, retainage is an unneeded double protection which places a severe burden on contractors and subcontractors, yet affords no extra assurance to the Government's interests.

Senator DANFORTH. I must interrupt you, Mr. Callas. I am sorry to say that we have another vote now on the floor of the Senate. I will have to leave. I will be back in about 15 minutes. The subcommittee will stand in recess.

[Recess taken.]

Senator DANFORTH. You may proceed, Mr. Callas.

Mr. CALLAS. The impact of retainage, Mr. Chairman, on small business construction firms is staggering and is actually counterproductive. First of all, this policy of withholding a portion of the requisitioned funds from the contractor each month places a severe restraint on the contractor's operations by reducing his cash flow. These moneys due the contractor, which he has already paid out weekly for payroll, materials, supplies, equipment rental, fuel, et cetera, must be quickly replaced in order for him to continue his ongoing, day-to-day operations. The moneys must be made available by borrowing at today's high interest rates. This practice places such a heavy financial burden on contractors that they often must reduce their scope of work or avoid participating in contracts where retainage is required.

The amount of retainage, usually 10 percent, is often greater than the total markup on the project, and the retainage is often withheld for considerable periods after the contract has been completed. Firms with limited capital, which have retainages outstanding for long periods of time, are strapped financially and therefore unable to meet their obligations when due.

My company was awarded a $740,000 construction contract for the U.S. Fish and Wildlife Service's Fisheries Academy Training Center at Leetown, W. Va., in July 1979. All contractual work was completed, and the final requisition for payment was submitted to the proper authorities on January 9, 1981. After many phone calls, letters, and finally assistance from our U.S. Senators and Congresswoman, we were paid the retainage of $37,002. In September 1981, 8½ months after completion of the project, we were forced to finance our company's construction operation by borrowing short-term funds at rates up to 20 percent. Our gross profit on the project was less than 6 percent.

My firm was awarded a $3 million construction contract at the National Fire Academy in Emmitsburg, Md., in May 1980. The students occupied the remodeled classroom buildings in September 1981. Eleven months later, retainage of $79,500 was finally paid on this project, just last week.

Currently, Mr. Chairman, my company has a total of $1.1 million withheld in outstanding retainage for 13 completed and ongoing projects. I am enclosing an attachment for the record which specifies the amounts retained from each project.

When the general contractor does not get paid, the subcontractors are not paid. Nonpayment of retainage is one of the biggest causes of disputes on Government construction projects—another reason many contractors will not bid Federal construction projects.

After some 35 years in this tough, extremely competitive business as a prime contractor, I strongly urge you and your committee to draft the appropriate legislation which would prohibit all Government agencies from withholding any retainages from any Federal contractors and subcontractors in order for them to better finance their construction operations, to provide financing for improved production methods, and to assist them to grow. The ultimate savings will be realized by the Federal Government and the taxpayers when contractors lower their bid prices in anticipation of no retainage.

Thank you, Mr. Chairman.

Senator **Danforth**. Gentlemen, thank you very much. Without objection, the attachment to your statement, Mr. Callas, will be inserted in the record at this point.

[The attachment follows:]

CALLAS CONTRACTORS, INC.
CONTRACT RETAINAGE
AUGUST 18, 1982

	PROJECT	AMOUNT OF RETAINAGE OUTSTANDING
1.	AOPA Office Building	$ 46,845
2.	AOPA Graphic Arts Building	1,550
3.	Avemco Office Building	101,892
4.	First National Bank - Germantown	14,131
5.	Fort Ritchie Sewage Treatment Plant	---
6.	Fort Detrick - Isolation Room	4,900
7.	State Use Industries - Food Processing Plant	25,044
8.	Leetown Siring and Reservoir Development	19,573
9.	Chessie System - Lift Station	960
10.	Contract 1 - Hagerstown Water Pollution Control	587,249
11.	Washington Garden Apartments	277,254
12.	MD Department of Environment Services - Sewage TMT Plant	16,856
13.	3M	4,230
		$ 1,100,484
	Shady Grove	
	Leetown - Holding in addition to retainage	68,417

ATTACHMENT I

Senator DANFORTH. If there were no flow-down provision in the bill, what would be the result with respect to retainage between the prime contractor and the sub?

Mr. CALLAS. I did not hear the first portion of the question, sir.

Senator DANFORTH. If the bill does not have a flow-down requirement, then what will be the result with respect to the relationship between the general contractor and the subcontractor?

Mr. CALLAS. I would have to say, Mr. Chairman, that it would revert back to the integrity of the prime contractor. I am very sincere in my remarks. I am here today to help subcontractors.

We only do 15 to 20 percent of the job. The rest of the job is subcontracted. I have subcontractors calling me continually.

In fact, before I left this morning, I received a call from a minority contractor who is setting the reinforcing steel on the city of Hagerstown's water pollution control job. The job has gone for over 2½ years. The contract was for $93,000. My accountant told me this morning that we have retained $5,300, which is 5 percent of the total contract.

He said that he did not have money for his payroll and asked if I could help. It is $5,300. We do not have a nickel. I signed 240,000 dollars' worth of material and equipment checks until the wee hours of this morning, and our bank balance is zero. I told the minority contractor, Mr. Hayward, that I would borrow the money for him tomorrow. He has done a super job for us. He does not have a nickel either, but he cannot borrow any money. So tomorrow I will go to my bank and see whether I can get the $5,300. In any case, I will certainly give him half of it.

That is our policy, Senator. We certainly would not withhold the money from the subcontractors.

Senator DANFORTH. Do you agree with that, Mr. Rhyne?

Mr. RHYNE. Yes, sir. I think, as Mr. Jones stated, it is up to the subcontractor to do business with general contractors.

Senator DANFORTH. That is the Georgia position, is that right?

Mr. RHYNE. We have some reputable general contractors.

Mr. CALLAS. That is the Maryland position, too, Senator, I assure you.

Senator, I would like to go one step further. I mentioned to you that I am a member of the Associated Builders & Contractors. We have 17,000 member firms across the country. I have been involved with the association for 16 or 18 years. I can say unqualifiedly that the majority of the people I know—and I know hundreds of them—feel exactly the same way that I do. They run legitimate firms. They work hard for their money, and they know that the job cannot move without the subcontractors.

I have to echo what Mr. Rhyne from Georgia said. I speak for Maryland and the other 48 States.

Senator DANFORTH. Do you think that the subcontractors who feel that without flow-down they would never see the benefits of the bill, that they would have retainage applied to them even if it were not applied to the general, are unduly cynical.

Mr. CALLAS. I may be speaking out of turn, Mr. Chairman, but if the subcontractor has that opinion of the general, he should not have a subcontract with him in the first place, retainage or not. The general would probably take advantage of him anyway. We are not all heroes. We do not all wear white hats, but I can speak for the majority of them whom I know. They do provide for their subcontractors.

I am going out of my way for my minority subcontractor. There are plenty like me out there. There are some tough times out there, but they are doing the same thing I am doing.

Senator **Danforth**. Do you agree with that, Mr. Rhyne?

Mr. **Rhyne**. Yes, sir. One of the contractors brought up the point that he had difficulty getting a contract. The owner is required, and will furnish at any time, a copy of the contract if any subcontractor goes directly to the owner of the project. He does not have to rely upon the integrity of the general contractor if he has suspicions about him.

As Mr. Callas said, if a subcontractor does work for someone of whom he is suspicious, he is in the wrong business.

Mr. **Callas**. Normally, the retainage is specified in the specifications, so the subcontractors do not really have to get a copy of the contract between the contractor and the owner. The retainage is specified in the specifications. He has a copy of it, just as the rest of us do.

Senator **Danforth**. Gentlemen, thank you very much.

The hearing is adjourned.

[Whereupon, at 12:10 p.m., the subcommittee was adjourned.]

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Calendar No. 932

97TH CONGRESS
2D SESSION

S. 1782

To amend section 305 of the Federal Property and Administrative Services Act of 1949 pertaining to contract progress payments made by agencies of the Federal Government, providing for the elimination of retainage in certain instances, and for other purposes.

IN THE SENATE OF THE UNITED STATES

OCTOBER 28 (legislative day, OCTOBER 14), 1981

Mr. WEICKER (for himself, Mr. NUNN, Mr. DURENBERGER, Mr. HUDDLESTON, Mr. MATTINGLY, Mr. BURDICK, Mr. MURKOWSKI, Mr. HELMS, Mr. HAYAKAWA, Mr. CHILES, Mr. ANDREWS, Mr. HOLLINGS, Mr. SARBANES, Mr. JOHNSTON, and Mr. DANFORTH) introduced the following bill; which was read twice and referred to the Committee on Governmental Affairs

SEPTEMBER 30 (legislative day, SEPTEMBER 8), 1982

Reported by Mr. ROTH, with an amendment in the nature of a substitute

[Strike out all after the enacting clause and insert the part printed in italic]

A BILL

To amend section 305 of the Federal Property and Administrative Services Act of 1949 pertaining to contract progress payments made by agencies of the Federal Government, providing for the elimination of retainage in certain instances, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

~~That this Act may be cited as the "Small Business Contract Payment Procedures Act".~~

~~SEC. 2. Section 305 of the Federal Property and Administrative Services Act of 1949 (41 U.S.C. 255) is amended by adding at the end thereof the following:~~

~~"(d) Whenever an executive agency makes progress payments pursuant to the authority granted under subsection (a)(1)—~~

~~"(1) such progress payments shall be made monthly as the work proceeds, at more frequent intervals as determined by the contracting officer, or at intervals stipulated by the contract;~~

~~"(2) if the contracting officer finds that satisfactory progress toward completion of performance of the contract was achieved during any period for which a progress payment is to be made, he shall authorize such payment to be made in full without retention of any percentage of the contract price; and~~

~~"(3) if the party performing the contract is a small business concern, as defined in section 3 of the Small Business Act, which has furnished an adequate performance bond, as determined by the contracting officer, he shall authorize such payment to be made in full without retention of any percentage of the contract price.".~~

That this Act may be cited as the "Construction Contract Payment Procedures Act".

FINDINGS

SEC. 1. The Congress finds that—

(1) the present practice of retaining a portion of progress payments otherwise due to contractors performing satisfactory work on Federal construction projects places an unnecessary and unfair financial burden on such contractors, adversely affecting their financial position by restricting cash flow and often requiring otherwise unnecessary borrowing;

(2) the highly adverse effects of unnecessary retainage fall most heavily on small construction firms, restricting entry of such firms into the Federal procurement marketplace as either prime contractors or subcontractors;

(3) the current retainage practice, inadequately related to the contractor's performance, represents an unnecessary burden on the Federal procurement process;

(4) other existing requirements currently applicable to Federal construction contracts provide the Government with adequate protection against the default of a contractor;

(5) the discretion accorded the contracting officer to withhold a portion of progress payments otherwise due the contractor upon making a finding of untimely or otherwise unsatisfactory performance provides adequate protection to the Government's interest; and

(6) the elimination of unnecessary retainage under the provisions of this Act will result in cost savings to the taxpayer and improved relations between the Government and its contractors.

PROGRESS PAYMENT PROCEDURES

SEC. 2. Section 305 of the Federal Property and Administrative Services Act of 1949 (63 U.S.C. 396; 41 U.S.C. 255) is amended by adding at the end thereof the following new subsections:

"(d) Whenever an executive agency elects to make progress payments under a construction contract pursuant to subsection (a)(1)—

"(1) such progress payments shall be made monthly, or at such more frequent interval as is stipulated in the contract;

"(2) such progress payments shall be made in full to the contractor without retention of any of the progress payment due unless the contracting officer finds and determines that the contractor is not making timely or otherwise satisfactory progress toward the

completion of the contract in accordance with its terms and conditions;

"(3) upon making a finding and issuing a determination that a contractor is not making timely or otherwise satisfactory progress, the contracting officer may retain from each of one or more progress payments due such amount, not exceeding 10 per centum of such progress payment, as is necessary to protect the Government's interest in timely and satisfactory performance of the contract;

"(4) amounts retaining under clause (3) may be released whenever the contracting officer finds that the contractor is making such satisfactory progress; and

"(5) upon the executive agency's final acceptance of the work under the construction contract, any amount still retained under clause (3) shall be promptly paid to the contractor in accordance with the terms and conditions of the contract and shall be subject to the provisions of the Prompt Payment Act (96 Stat. 85; 31 U.S.C. 1801 et seq.).".

CONSTRUCTION SUBCONTRACT PAYMENT PROCEDURES

SEC. 3. To obtain fully the intended benefits of this Act, prime contractors are urged to make provision in their agreements with their subcontractors and material suppliers for the prompt payment in full of any progress payments other-

wise due, without retainage of any part thereof, unless the prime contractor finds that the performance of the subcontractor or material supplier is untimely or otherwise not in accordance with the terms and conditions of its agreement with the prime contractor. Similarly, subcontractors below the first tier of subcontractors are urged, in turn, to make provision in their agreements to accord the same fair treatment concerning prompt payment in full of any progress payments otherwise due to their subcontractors or material suppliers, in accordance with the same standard.

REGULATIONS

SEC. 4. Regulations to implement this Act and the amendments made by this Act, including regulations specifying contract provisions, shall be issued and become effective within one hundred and twenty days after the date of enactment of this Act.

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

May 14, 1982

B-207097

The Honorable William V. Roth, Jr.
Chairman, Committee on Governmental Affairs
United States Senate

Dear Mr. Chairman:

You requested our views on S. 1782, a bill "to amend Section 305 of the Federal Property and Administrative Services Act of 1949 pertaining to contract progress payments made by agencies of the Federal Government, providing for the elimination of retainage in certain instances, and for other purposes." The proposed bill amends Section 305 of the Act by adding subsection (d). While we have not completed any studies which would allow us to provide audit-supported comments on the bill's proposed provisions, we are providing some observations for your consideration based on our general experience in reviewing procurement activities.

1. Proposed subsection (d)(1) of the bill provides that progress payments shall be made monthly as the work proceeds, at more frequent intervals as determined by the contracting officer, or at intervals stipulated by the contract.

While it may be desirable in some cases to have the contracting officer authorize progress payments at more frequent intervals than monthly, we believe that making payments more frequently than once a month could create an unnecessary administrative burden on agencies. Therefore, to help assure consistent treatment of contractors by Federal contracting officers and to aid in reducing the administrative burden, we believe some criteria or guidance should be provided to help contracting officers in deciding when to authorize payments more frequently than once a month.

2. Proposed subsection (d)(3) provides that if the party performing the contract is a small business concern and has provided an adequate performance bond as determined by the contracting officer, the contracting officer shall authorize progress payments to be made in full without retention of any percentage of the contract price.

This provision would seem to permit full payment of the contract price even though the contracting officer has information showing that the contractor may not be performing satisfactorily. In our opinion it is not in the Government's best interest to make full progress payments when the contracting officer has knowledge that less than satisfactory progress towards completion of the contract is being achieved. Where the contracting officer has knowledge that the contractor is not performing satisfactorily, we believe the contracting officer should have the flexibility to retain a percentage of the progress payment.

We appreciate this opportunity to comment on the proposed legislation.

Sincerely yours,

Charles A. Bowsher
Comptroller General
of the United States

GENERAL COUNSEL OF THE DEPARTMENT OF DEFENSE

WASHINGTON, D.C. 20301

JUN 25 1982

June 22, 1982

Honorable William V. Roth, Jr.
Chairman, Committee on Governmental Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Reference is made to your request for the views of the Department of Defense on S. 1782, 97th Congress, "Small Business Contract Payment Procedures Act."

S. 1782 provides that progress payments to a small business be made at least monthly with no reduction of contract price if satisfactory progress is being made or if the contractor has furnished an adequate performance bond.

S. 1782 would amend section 305 of the Federal Property and Administrative Services Act of 1949 (41 U.S.C. 255). Section 305 is part of chapter 4 of title 416 which is not applicable to the Department of Defense. Our authority for progress payments is derived from 10 U.S.C. 2307 which would not be modified by S. 1782. Thus, the Act would not affect the Department of Defense.

Normally, we do not offer comments on proposed legislation which will not impact on the Department of Defense. Because the other agencies have tended to follow the Department of Defense in establishing their progress payment procedures and because we have recently made substantial changes to our procedures, we believe it is appropriate to furnish you with our thoughts on this matter.

Prior to March 1981 small businesses were eligible to receive bi-weekly progress payments at the rate of 85 percent of incurred cost. As of August 28, 1981, we revised our regulations and small businesses may now receive monthly progress payments at the rate of 95 percent of incurred cost. We made these small changes in recognition of the fact that small businesses were in need of additional financing as a result of inflation and high interest rates. Most of them were unable to bill more frequently than monthly because the expense necessary to determine contract cost at mid-month is prohibitive. Finally, over the past few years we have instituted a fast payment procedure under which a contractor may receive progress payments prior to administrative review of its vouchers if the contracting officer, based on the advice of the Department Contract Audit Agency, has determined that the contractor's accounting system is adequate.

Due to these changes in our procedures and because small businesses may bill for incurred cost, they have little or no investment in work-in-process under government contracts eligible for progress payments. In addition, the administrative costs for both the contractor and the government have been minimized.

As we stated previously, many of the other agencies tend to follow the Department of Defense's procedures in this area. In addition, the Office of Federal Procurement Policy has proposed uniform policies for all Federal agencies.

Under the circumstances, if S. 1782 is enacted, there would be little additional cost that could be paid to the small contractor. In order to grant these additional payments, however, it would be necessary to establish costly administrative procedures to determine that contractors are making satisfactory progress toward contract completion. Therefore, we do not believe that the proposed law would prove to be beneficial to either the small businesses or the government and we recommend against its enactment.

The Office of Management and Budget advises that, from the standpoint of the Administration's program, there is no objection to the presentation of this report for the consideration of the Committee.

Sincerely,

William H. Taft

William H. Taft, IV

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

9 1982

JUL 9 1982

Honorable William V. Roth, Jr.
Chairman, Committee on
Governmental Affairs
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

This is in response to your request for the views of the Office of Management and Budget and the Office of Federal Procurement Policy on S.1782, a bill "To amend Section 305 of the Federal Property and Administrative Services Act of 1949 pertaining to contract progress payments made by agencies of the Federal Government, providing for elimination of retainage in certain instances, and for other purposes."

S.1782 would amend section 305 of the Federal Property and Administrative Services Act of 1949 (41 U.S.C. 255) by requiring, under a contract which provides for progress payments, a Federal contracting officer to make full payment of such progress payments if, when due, it is determined that "satisfactory progress towards completion" has been made. If the contractor were a small business, full payment would be required if the business had provided an "adequate performance bond," as determined by the contracting officer. The contracting officer would not be permitted to retain a percentage of the contract price as security for the completion of a contract.

We oppose S.1782. By prohibiting the payment of only a percentage of incurred costs in making progress payments, S.1782 would deprive Federal agencies of an important tool currently used in contract administration. The retention of a small amount is consistent with commercial construction contracting practice, the practices of State and local governments throughout the Nation, and serves to preclude overpayments. Further, it is an incentive to complete a variety of contract requirements, including defects and omissions at the end of the project, submission of Davis-Bacon payrolls, completion of maintenance manuals, record drawings, etc., all of which are hard to obtain in a timely fashion without the leverage of a retained amount. Further, the existence of a performance bond does not ensure timely performance under a contract.

In the interest of assisting small businesses, procurement regulations currently provide for progress payments of 95% of costs incurred for small business contractors. We believe the present arrangement represents a realistic balance between the interests of small business contractors and those of the Government.

The fiscal impact of the bill would be far greater than its title might indicate. Although evidently intended to benefit small businesses primarily, the bill would apply to contracts with all Government contractors, large or small.

In this connection, OMB recently submitted to the Congress a proposal for a uniform Federal procurement system, along with legislation needed to implement the system. Progress payments and retainage problems are among the issues to be examined as we seek improvements in the procurement process.

For these reasons, OMB opposes enactment of S.1782.

Sincerely,

Naomi R Sweeney

Naomi R. Sweeney
Acting Assistant Director
for Legislative Reference

AMERICAN INSURANCE ASSOCIATION

1025 Connecticut Ave., N.W.
Washington, D.C. 20036
(202) 293-3010

September 3, 1982

The Honorable John C. Danforth
Chairman, Subcommittee on Federal
Expenditures, Research & Rules
44 Capital Hill Apartments
128 C Street NE
Washington, D.C. 20510

RE: S.1782 - "Small Business Contract Payment Procedures Act"

Dear Senator Danforth,

The American Insurance Association is submitting the following statement for the record setting forth our concerns regarding S.1782, a bill which would alter drastically the practice of retainage on government construction projects. American Insurance Association is a trade association representing 168 mostly stock property and casualty insurance companies with written premiums in excess of $30 billion as of December 31, 1980. In addition to writing all lines of insurance, the member companies are involved to a significant extent in writing performance and payment surety bonds.

Senate Bill 1782 would serve to substantially eliminate the withholding of retainage on federal contracts by mandating in certain instances the release of all progress payments to contractors under contracts for property and services. In essence, this bill would prohibit a contracting officer from withholding retainage if he determines that satisfactory progress toward completion of performance of the contract was achieved during the period for which the progress payment is being made. Furthermore, such retention would

WILLIAM O. BAILEY, CHAIRMAN PETER LARDNER, VICE CHAIRMAN EDWARD H. BUDD, VICE CHAIRMAN T. LAWRENCE JONES, PRESIDENT

be altogether prohibited if the contractor is a "small business concern" (as defined in section 3 of the Small Business Act) which has furnished an adequate performance bond regardless of whether satisfactory progress toward completion of performance has been observed by the contracting officer.

Retainage has been defined as "the practice of withholding typically 10% of progress payments for as long as a year after completion of a project." This definition appeared in an article in the May 13, 1982 edition of Engineering News Record (ENR). The article discussed both this bill and its House counterpart, H.R. 5022, and made reference to alleged negative effects which retainage has on the bidding and performance of government contracts. We submit, however, that retainage, if carried out in accordance with the way it is intended for construction projects, will produce desirable results for the government as well as protection for the surety without withholding such money for excessively long periods as was suggested in the ENR article.

We agree that the cash flow problems resulting from tying up a contractor's working capital for excessively long periods of time deserves the attention of the Congress. We suggest, however, that the solution lies not in the elimination of retainage but in speeding up the release of the non-retained portion of the progress payments. In this regard, we believe the recent enactment of the Prompt Payments Act, Public Law 97-177, will, if properly implemented, alleviate much of this problem.

The practice of retainage on construction work, both public and private, has been enforced for centuries, even prior to the period when corporate suretyship displaced personal suretyship on construction contracts. Beginning in the last quarter of the 19th century, corporate suretyship was built upon existing retainage policies which had previously been imposed by owners as a means of obtaining fulfillment of the performance obligation undertaken by the contractor. It must be kept in mind that the contractor is the primary obligor under its contract with the owner. The corporate surety is but a secondary obligor whose participation in the completion of the contract is not mandated until such time as the owner terminates the contract. Once that event occurs, the surety, by subrogation, accedes to the rights of the owner relative to the security afforded by the retainage. If there is no security, the loss to be realized by the surety is arithmetically increased.

We have noted that this bill completely prohibits the withholding of retainage from a small business concern only if that small contractor has furnished an adequate performance bond. In substance, the sponsors of this bill are saying that retainage is unnecessary for the small business concern only when a surety bond is involved. We submit that a surety bond was never intended to take the place of retainage.

It must be remembered that a performance bond is not an insurance policy protecting a contractor against financial disaster or inability to perform a task. Rather, it is a guaranty to the obligee that the contractor will abide by its contractual obligations. Requiring such a bond is the obligee's way of eliminating the possibility of suffering inconvenience or financial loss due to the inability of the contractor to complete its task. As a guarantor, the surety has a right to expect the very same protection which the obligee would require if there was no bond. Would the sponsors of this bill be so anxious to eliminate retainage if it were not for the fact that performance bonds are generally required on federal contracts exceeding $25,000? Would the members of the Senate or the House contemplate such a measure if bonds were not required and the government, via the taxpayer, was thereby forced to sustain losses unabated due to the lack of sufficient retainage?

Retainage is, in the most basic sense, an inducement to a contractor to perform in accordance with its agreement. Prior to bonding, owners viewed it as a tool providing them with, in the event of a contractor's departure from the contract or default, immediate leverage to encourage the contractor to proceed with the job in accordance with its contract. A surety is in no better position to force a contractor to perform the job than an owner would have been without a bond. Therefore, the withholding of retainage is just as crucial for the surety as it is to an owner who did not require a bond. This is particularly true with respect to problems which arise with the contractor's performance during the late stages of construction when, if the contractor has received practically all of the contract funds, there is little incentive for him to return to correct inadequacies.

Often, the termination of a contract will occur during the middle or late stages of the work. As is standard procedure, the surety following notice of such termination will make a determination of the cost to correct any defective work and complete the unfinished portion of the project. If that total completion cost figure exceeds the total of the contract balance and bond penalty combined, the surety will most likely pay over the amount of the bond penalty to the government agency and walk away leaving the agency with a partially uncompensated loss. The agency would have no further recourse against the surety and could look only to the contractor (assuming he is still in business and not in bankruptcy) and any remaining contract balance. If retainage had not been withheld, the contract balance is that much smaller and the uncompensated loss that much greater. When we outline this scenario, we are pointing to a set of events which can and does occur.

In addition, there are other circumstances under which a surety may lawfully refuse to complete a contract following the termination of the contractor, thereby making the government's reliance on the existence and amount of retainage even more critical. Examples of such circumstances are when the surety has been determined by a court to have been discharged from its obligation due to some prejudicial act committed by the government agency or when the well-established legal concept that a surety is entitled to claim the same defenses available to its principal in response to a claim is interposed. These events do not occur infrequently.

We are very concerned with the power that would be granted to the contracting officer to refrain from withholding retainage for contractors not fitting the description of "small business concerns" based on a determination by the officer that the contractor is making "satisfactory progress toward completion of performance of the contract." We submit that it would be unwarranted to assume, at any stage during the course of the contract, that evidence of satisfactory progress on a particular part of the job is proof positive that the contract will be satisfactorily completed. In fact, even more alarming is the implicit assumption that these contracting officers are in all cases qualified to make such determination. If they are always qualified, we would propose that this bill be amended to provide that once a determination of satisfactory progress has been made, and the surety's interest has been jeopardized by the subsequent release of retainage, the government agency be foreclosed from claiming that that portion of the work was not performed in accordance with the contract.

AIA is particularly concerned with that section of the bill which appears to prohibit, under any circumstances, the withholding of retainage from a bonded small business concern. There is a very real possibility that the ability of small enterprises to obtain bonds on government jobs may be impaired if such provision is enacted. When deciding whether to write a bond, a surety will look to the financial background of a contractor, its level of expertise, the size of the job for which bonding is sought, the general risks of sustaining a loss given the foregoing facts and the terms and conditions of the contract which may adversely impact on the degree of risk involved. Certainly, a surety will look differently at an application by a contractor for a bond on a government project where retainage cannot be withheld than upon an application by that same contractor for a bond in the same amount on a job where retainage is provided for. The underlying concern in deciding whether to bond a particular project is how much of a risk of loss the surety would be exposed to; without retainage, that risk is greater.

We are cognizant of the cash flow problems faced by contractors performing federal construction jobs. As stated earlier, however, the solution to these problems is to make sure the government takes immediate action on the periodic requisitions for payment for work which has been completed. If the government agencies act in a timely manner, the cash flow problems would be greatly alleviated.

Conclusion

We oppose S.1782 as it is presently drafted because we believe that the present retainage standards protect not only the surety, but the government too. We would be happy to discuss our views in greater detail should the Subcommittee on Federal Expenditures, Research & Rules find it useful.

American Insurance Association appreciates the opportunity to comment on this legislation which is extremely important to the member companies.

Very truly yours,

Robert B. Shapiro
Counsel

RBS/mam

cc: Members of Subcommittee on
Federal Expenditures, Research
& Rules
William B. Montalto, Counsel

Statement of
The Associated General Contractors of America
Presented to the
Subcommittee on Federal Expenditures, Research and Rules
Committee on Governmental Affairs
United States Senate
August 18, 1982
on the Topic of
Retainage on Government Construction Contracts

SKILL RESPONSIBILITY INTEGRITY

AGC is:

- More than 30,000 firms including 8,500 of America's leading general contracting firms responsible for the employment of 3,500,000-plus employees;
- 113 chapters nationwide;
- More than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utility facilities;
- Approximately 50% of the contract construction by American firms in more than 100 countries abroad.

The Associated General Contractors of America (AGC) and its 113 chapters nationwide are comprised of approximately 30,000 firms, including more than 8,500 of the nation's leading general contracting companies that perform more than $100 billion of construction annually. AGC's members also perform approximately 50 percent of the contract construction by American firms in more than 100 countries abroad. More than 95 percent of AGC's member firms are small businesses, as defined by the Small Business Administration's size standards for general construction contractors.

The Associated General Contractors of America endorses the principle of retention as a basic and prudent business practice of the construction industry. The text of AGC's formal policy on retention is appended to this statement. Recognizing the need to lower the cost of construction, we believe it is essential that the amounts retained be reasonable and that funds so retained be released as expeditiously as possible. Undue delays in the releases of retained funds impose unwarranted hardships on all contractors and further compound the cash flow problem in the industry. However, AGC opposes the mandatory elimination of retainage on federal construction contracts.

Retainage, like a performance bond, provides needed protection for the owner; each, however, serves a distinctly different purpose.

A performance bond guarantees performance for the whole project while retainage protects the owner during the course of the project. A performance bond is usually called only in the case of default by a contractor on the project. Retainage is an interim measure and is the lever with which the owner can return a contractor to the project to correct minor deficiencies in the project.

Elimination of retainage may well force surety companies to apply substantially more stringent bond underwriting practices and procedures, the effect of which could be fewer bidders on federal construction projects resulting in higher prices for federal work. Such a result would obviously conflict with the government's desire to increase competition for its procurement.

AGC believes that any action by Congress on retainage is unnecessary. Presently, under the standard construction contract of the Federal Government, contracting officers of the government have the right to adjust the amount of retainage on a project by project basis. Retainage held by these contracting officers will in no case exceed 10% of the progress payment and can be as low as zero, depending on the progress of the project. This determination rests in the hands of the contracting officer whose job it is to protect the interest of the Federal Government.

AGC RETENTION POLICY

The Associated General Contractors of America endorses the principle of retention as a basic and prudent business practice of the construction industry. Recognizing the need to lower the cost of construction we believe it is essential that the amounts retained be reasonable and that funds so retained be released as expeditiously as possible. Undue delays in the release of retained funds impose unwarranted hardships on all contractors and further compound the cash flow problem in the industry.

AGC policy calls for retention of not more than 5% of the amount due on any contract, except that for building projects, the Building Division has established a policy of 10% retention to 50% of project completion with no further amounts being withheld provided satisfactory progress is maintained.

Upon substantial completion of the entire project, a substantial completion certificate shall be executed. Within 30 days thereafter, final payment, including all unpaid retention, shall become due and payable. If, at the time of substantial completion, there are uncompleted minor items of work called for under the contract or change orders, the resolution of which extends the project completion, the Architect/Engineer and the Owner shall jointly prepare a list of such items yet to be completed. The Owner may withhold a sum not to exceed 150% of the estimated cost of completing any such unfinished minor items of work. Monthly thereafter, the Owner shall pay the Contractor in full the amount billed for each item of work as it is completed or partially completed.

Procedures to allow the contractor to post securities in lieu of retention have long been advocated by AGC. AGC continues to favor this policy and will continue its efforts to secure the adoption of this procedure by all owners whether in the private or public sector.

Reduced retention may not provide the general contractor with sufficient legal and economic protection. All AGC members are cautioned to review their current policies regarding the bonding of subcontractors.

Statement
on Behalf of the Associated Specialty Contractors, Inc.
For the
Subcommittee on Federal Expenditure, Research and Rules
of the
Governmental Affairs Committee
of the
U.S. Senate
on S. 1782

The Associated Specialty Contractors, Inc. (ASC) is an "umbrella" organization of eight national associations*/ of construction specialty employer contractors. The segments of the construction industry represented by ASC affiliates consist of about 165,000 business establishments with annual sales of about $63 billion and 1,300,000 employees. The large majority of these firms, probably 98 percent, are small business enterprises.

ASC strongly supports S. 1782 to eliminate retainage from contractors' payments on most construction contracts of executive agencies. However, we vigorously urge the addition of language incorporating an explicit and enforceable provision requiring the benefits of the legislation to flow through to subcontractors.

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*/ Mason Contractors Association of America, Mechanical Contractors Association of America, Inc., National Association of Plumbing, Heating and Cooling Contractors, National Electrical Contractors Association, National Insulation Contractors Association, National Roofing Contractors Association, Painting and Decorating Contractors of America, and Sheet Metal and Air Conditioning Contractors National Association, Inc.

The practice of retaining a percentage of progress payments may have had some justification at one time. However, in today's business climate and practice it has outlived its usefulness and is proving to be a deterrent to vigorous competition in the construction industry by small business firms and to cause unnecessary costs to government.

There were two basic reasons for establishing the practice of retaining a percentage of progress payments due construction contractors and subcontractors for work already performed.

1. The unpaid balance of amounts due the contractor or subcontractor was used as an incentive for his satisfactory completion of all work on the contract. Non-payment of the retained funds was omnipresent as a penalty to be enforced in case of non-performance.
2. Retained funds constituted a kind of trust fund which could be used to pay subcontractors, suppliers and job site employees of the contractor in the event of his default. This insulated the owner from legal actions against the property being improved. The funds could also be used by the owner to pay another contractor to complete the work on which the first contractor had defaulted.

Two other reasons have sometimes motivated private owners to require retainages, although these reasons should never have been a factor in Governmental procurement:

3. The owner can hold and invest the contractor's funds to his own benefit during the period of construction.
4. Retainage tends to eliminate from bidding competition any underfinanced contractors, since the severe cash flow

> problems generated by the practice of retention make it difficult for any firm to compete, regardless of its competency to perform the work, unless it is well capitalized and has good borrowing capacity. As a matter of fact, 20 to 30 years ago, when working capital could be borrowed at four or five percent interest, it was not unusual for better established and larger contractors to argue in favor of maintaining fairly high retainage rates as a deterrent to "excessive" competition.

None of the original justifications remain valid today, with existing bonding and performance provisions. The government has two other more effective methods of assuring timely and proper performance. Performance bonds and the authority of a contracting officer to terminate contractors for default because of their failure to perform in accordance with the contract and to charge the contractor the full amount paid by the government for having others complete the contract are potent tools to assure prompt completion. Labor and material payment bonds assure the payments of subcontractors, suppliers and workers. Government, by law, is exempted from liens filed by such creditors, so the need does not exist to maintain funds to pay creditors. Furthermore, subcontractors, suppliers and labor have been foreclosed from making legal demands on funds retained from contractors on Federal construction because there is no privity of contract between the creditors and the government.

It is patently unreasonable to withhold portions of progress payments for work which has been satisfactorily performed over a period of two or three years in order to assure contractor completion of the last few corrections and omissions. Following substantial completion the Government might withhold a sufficient amount from the last progress payment to cover the reasonable cost of making small, final, so-called "punchlist" corrections. It is universal practice for the representative of a construction owner to make a detailed final inspection of construction work upon substantial completion and to list each remaining deviation from the plans and specifications, omissions, needed corrections of defective work or materials, or damages to installations incurred during the construction process. This list is the "punchlist". Its use does not preclude holding the contractor liable for additional corrections during the warranty period, normally up to one year after final completion.

There is no question about the contractual and moral responsibility of each contractor to perform punchlist work. It is expensive and aggravating work, however, since most, if not all, of the contractor's employees have left the job site and gone on to other projects. Skilled workers, knowledgeable about the plans and specifications and how the project was built, must be taken from other jobs and brought back with necessary tools and equipment to perform the punchlist work. Although contractors recognize their responsibilities to do this work, those who have had unsatisfactory relations with contracting officers or inspectors and who expect additional nitpicking corrections following completion of what should be a final punchlist may delay performance of the punchlist work in the hope that final payment will indeed be made shortly after such completion and that all corrective work can be completed at one time.

Even more important is the fact that most of the work actually has been performed by subcontractors who have learned , usually from bitter experience, that they are unlikely to receive final payment and release of retainage until all the other work of all the other contractors on the job has been completed and the prime contractor has received final payment for the entire project. Subcontractors can wait six months to a year or even much longer after completion of their work, including all punchlist work, before they receive final payment. Having no incentive to complete their work any earlier than the work of others has been completed, subcontractors sometimes are inclined to postpone punchlist work until a more convenient time. It is important, both to achieve satisfactory performance and to be fair and consistent, that legislation eliminating retainage on prime contractors also provide that _no funds be retained by prime contractors from subcontractors except in circumstances parallel to those justifying retainage by the Government from payments to prime contractors_ under this Act. Implementing regulations should require that subcontractors, in turn, assure the flow-through of such provisions to sub-subcontractors. Regulations should also assure that any amounts retained from the final payment to cover the cost of punchlist work be released to the prime contractor and, subsequently, by him to each subcontractor upon the completion of that subcontractor's punchlist.

Retainage on Federal projects seldom if ever accomplishes the original objective of assuring payment of subcontractors suppliers and labor. Rulings of the Court of Claims and the Comptroller General prevent such creditors from bringing action against the Government to prevent release of the retained funds to the prime contractor until all of his obligations have been fulfilled or to secure payment for the creditors from the retained funds. Such legal action is foredoomed because there is no privity of contract between subcontractors and the Government. (Comp. Gen. Dec. D-174534) (10 Dec. 1971); (Comp. Gen. Dec. B-205165 (8 Jan.1982).

The payment bond required of prime contractors by the Miller Act provides a much more satisfactory recourse for creditors. Prime contractors have every right to require that subcontractors post performance and payment bonds as well, in order to protect the prime contractor, the sub-subcontractors, suppliers and the laborers of the subcontractors.

The use of retainage requirements to "pre-qualify" contractors by making it impossible for those who are underfinanced to participate in Governmental construction for this reason not only is an ill-advised method of judging the competency of contractors but will not work. Again, bonding requirements are more satisfactory since sureties must satisfy themselves of the competency and financial capacity of those for whom they write bonds. Many well-managed and competent firms are seriously hurt by requirements for retainage when they must borrow working capital at today's high rates to replace the funds they have earned but have not received. Two scenarios can be visualized:

> Scenario A: The low bidder failed to allow enough in his cost estimate to pay the high interest rates required to borrow working capital to keep the project and his other work going during the unknown period of time that his retainage may be tied up. This omission in the estimate very likely could be the reason he was low bidder. As a result of this failure, he is forced to continue in a negative cash flow position so long that he no longer is able to borrow funds at any interest rate and thus is unable to pay his labor and suppliers. He defaults and other contractors must be employed at much higher cost to do the work. By this time the low bidder, who has been forced into default by retainage, has no assets to pay the additional costs for

completion, which in most cases far exceed the amount retained. The very purpose of retainage thus has been frustrated by the retainage itself - namely, assurances that performance will be satisfactory and that creditors will be paid.

Scenario B. The bidders have allowed in their cost estimates for the cost of financing the retainage with enough contingency factors included to take care of delays of several months after completion before receipt of the retained funds and also to take care of higher interest rates. The result is much higher construction costs, since allowances have been included in all the bids for borrowing funds for working capital.

The Government can certainly borrow money at a significantly lower rate than contractors can for short-term working capital loans. Private owners who use retained funds to help finance the work are paying so much more for the construction than they are gaining from the "interest-free loans from contractors" that it is not an economic practice. Since the Government can borrow at lower rates than private construction purchasers, it becomes even more uneconomic for the Government to follow such a practice.

The nature of the construction industry should be examined to consider the cash flow problems caused by retainage. All contractors must pay wages weekly, obviously retaining nothing from the earnings of employees, which would be unlawful. Suppliers must be paid monthly. It is highly unusual to withhold retainage on the payments due suppliers for materials which have been delivered. In some cases, progress payments must be made on specially fabricated equipment long before it is delivered. Other materials and equipment often are purchased long before installation to assure that they will be on the job site when needed and, in some cases, to hedge against increasing prices. Although on most private work contractors are now paid for such stored materials, this often is not true on federal work.

Almost all overhead costs either must be paid weekly in the form of wages and salaries or monthly. Contractors operate on very small profit margins, often around two to four percent, so in most cases the amount retained usually exceeds the contractor's profit, which he obviously needs to buy additional tools and equipment and to pay stockholders for the use of their capital.

Thus for many months the contractor is paying out more money in the costs of what he has installed for the benefit of the Government than he has received in return in payment. The deficiency must be made up in some way. Since few contractors have extensive capitalization, it usually must be made up by borrowing at interest rates ranging from 18 to 22 percent, usually well above the prime rate. Most of the contractors doing the work are subcontractors, 90 to 95 percent of whom qualify as small businesses under the Small Business Administration five million dollar size standard. Contractors of this size generally are not able to borrow money at the prime rate for relatively short term loans with no security other than the retained funds to be released at some unknown and distant time after the prime contractor has received his own retainages from the Government.

That most of the costs on construction projects are incurred by subcontractors is indicated by the 1977 Census of Construction Industries. Special trades contractors employed 51.5 percent of all on-site construction workers, compared with 12.0 percent employed by general building contractors, 21.3 percent by heavy and highway contractors and 15.2 percent by home builders. The Bureau of Labor Statistics has reported that 73.4 percent of the labor cost on hospital construction is incurred by special trades contractors and that on all General Services Administration Federal office building projects completed in 1973, 62.4 percent of the on-site labor hours were performed by employees of specialty or subcontractors. In some other types of construction the relative importance of subcontractor employment may be even greater. Although ratios of material purchases are not known, it is probable that those made by subcontractors are even greater compared with general contractor purchases than the ratios of labor utilization.

Specialty or subcontractors customarily furnish the labor, materials and management services to install all heating, ventilating, airconditioning, plumbing, electrical, mechanical equipment, steamfitting, elevators, boilers, painting, decorating, paperhanging, pipe and duct insulation, roofing, masonry, stone, alarm systems, communication systems, tile, terrazzo, marble, and ornamental ironwork. Structural steel erection, plastering, lathing, drywall, glazing and wall and ceiling insulation is also performed by subcontractors. In some cases so is site preparation, excavation, grading, concrete work, carpentry, hauling, crane operation, hoisting and other functions.

The following is a hypothetical cash flow illustration of a fairly small subcontract for $240,000 for a construction period of 18 months. Almost ideal conditions are assumed except for retainage, slow release of final payment (although no slower than is customary), and interest rates. These conditions include: completion on schedule; (2) payments received by the subcontractor in the month following billing, (3) no change orders; (4) some materials purchased prior to installation but not paid for by the owner; (5) costs as estimated; (6) only $1,000 of punchlist costs (included in the estimated costs); (7) punchlist work completed in the month following substantial completion; (8) retainage at 10 percent; (9) one month's delay in receiving the last progress payment while punchlist completion was being inspected; (10) four months' delay after final completion to receive retained funds; and (11) working capital borrowed at 18.5 percent, resulting in a net effective cost of 22 percent after borrowing to pay the interest. Total interest incurred to make up for the inability of the contractor to use the retained funds and for delayed reimbursement for stored materials equals $19,354, which is 8.1 percent of the contract price and 10.5 percent of the prime costs. This is an unconscionably high burden on the contractor and the Government.

Note, too, that the interest paid the bank loaning the contractor working capital to replace the retained funds exceeds the entire profit estimated by the contractor for his investment of capital for equipment, tools and management expertise to perform the work. This is hardly an equitable allocation of rewards.

HYPOTHETICAL CASH FLOW ILLUSTRATION

18 MONTH $240,000 SUBCONTRACT

	Amount	% of Total	% of Cost
Prime Costs	$185,000	77.1	100.0
Overhead	36,500	15.2	19.7
Profit	18,500	7.7	10.0
Total Contract Price	240,000	100.0	129.7

MOS. AFTER AWARD	INCURRED COSTS[1] & PRO-RATA PROFIT		PROGRESS BILLING	RETAIN-AGE	PAYMENT REC'D		CUM. INCUR'D LESS REC'D	MONTHLY FINANCING CHARGES
	CURRENT	CUMULATIVE			CURRENT	CUMULATIVE		
0	$ 2,000[2]	$ 2,000	$ 0	$ 0	$ 0	$ 0	$ 2,000	$ 37
1	5,000	7,000	5,000	500	0	0	7,000	128
2	12,000[3]	19,000	7,000[4]	700	4,500	4,500	14,500	265
3	16,000[3]	35,000	8,000	800	6,300	10,800	24,200	443
4	18,000[3]	53,000	10,000	1,000	7,200	18,000	35,000	641
5	18,000[3]	71,000	10,000	1,000	9,000	27,000	44,000	805
6	21,000[3]	92,000	11,000	1,100	9,000	36,000	56,000	1,025
7	11,000	103,000	11,000	1,100	9,900	45,900	57,000	1,045
8	12,000	115,000	12,000	1,200	9,900	55,800	59,200	1,083
9	12,000	127,000	12,000	1,200	10,800	66,600	60,400	1,105
10	13,000	140,000	13,000	1,300	10,800	77,400	62,600	1,146
11	13,000	153,000	13,000	1,300	11,700	89,100	63,900	1,169
12	13,000	166,000	13,000	1,300	11,700	100,800	65,200	1,193
13	12,000	178,000	14,000[5]	1,400	11,700	112,500	65,500	1,199
14	11,000	189,000	16,000[5]	1,600	12,600	125,100	63,900	1,169
15	10,000	199,000	18,000[5]	1,800	14,400	139,500	59,500	1,088
16	12,000	211,000	22,000[5]	2,200	16,200	155,700	55,300	1,012
17	15,000	226,000	25,000[5]	2,500	19,800	175,500	50,500	924
18	13,000	239,000	20,000[5]	2,000	22,500	198,000	41,000	750
19	1,000	240,000	44,000[6]	0	0	198,000	42,000	769
20	0	240,000	24,000[6]	0	18,000	216,000	24,000	439
21	0	240,000	24,000[6]	0	0	216,000	24,000	439
22	0	240,000	24,000[6]	0	0	216,000	24,000	439
23	0	240,000	24,000[6]	0	0	216,000	24,000	439
24	0	240,000	24,000[6]	0	24,000	240,000	0	0
25	0	240,000	0		240,000			19,354

Hypothetical Cash Flow Illustration
Page 12
Footnotes

(1) Excluding finance charges (interest on borrowings for working capital).

(2) Preplanning, engineering, procurement, and mobilization expense.

(3) Including materials and equipment purchased and stored for future installation but not billed.

(4) Including one-half of preplanning expense.

(5) Including previously purchased and stored materials and equipment billed after installation.

(6) Repeated billings for retainage after completion.

It is of the utmost importance that Congress recognize the interests of the Government in the performance, competetiveness, and survival of subcontractors regardless of considerations of privity of contract. There is already ample precedent for this disregard for the old theory of privity in laws and regulations on equal employment opportunity, affirmative action, monority business enterprise involvement, Buy America, and other matters of public policy in which prime contractors are required to insert and enforce particular provisions in subcontract agreements. In the case of retainage, the benefits of elimination will be realized only if the law prohibits prime contractors from retaining monies from their subcontractors when such funds are not to be withheld from prime contractors.

It is necessary that this be made a matter of law. General contractors are in a position of having much greater bargaining power than subcontractors when subcontracts are being written. The general contractor already has the job; the subcontractors are still trying to obtain their contracts. This is true even of the low bidders whose bids were used by the general contractor to prepare his bid. Only the General Services Administration among Government agencies now requires listing of subcontractors whose bids have been used and prohibits substitution of other subcontractors except for limited and specified reasons. Even GSA regulations provide only for listing of major subcontractors. Thus it can be expected that without requirements to the contrary, general contractors would impose retainage provisions in excess of those imposed upon them. The general contractor would be receiving "interest free loans" from his subcontractors for the duration of the project because he would pass along their requisitions for progress payments in full, together with his mark-ups, receive payment from the Government for the entire amount and then retain a portion of each subcontractor's payment.

A classic, but not unique, case involved Midland Engineering Co. et. al. v. John A. Hall Construction Company and U.S. Fidelity and Guaranty Co., heard by the U.S. District Court of the Northern District of Indiana (South Bend Division). In this case the general contractor was retaining more from the subcontractors' payments than was being retained from his payments on a school construction project. Long after their work was completed, seven subcontractors brought suit for final payment of the amounts the contractor had withheld. The subcontracts included a clause which said that the final payment to the subcontractor should be made immediately after final payment had been received by the general contractor. The Court found that the general contractor was holding $504,000 of subcontractors' money, but that the owner owed the contractor only $257,564. The delay in final payment involved 75 corrections required in the work performed by the general contractor. The Court noted that "a malefic general contractor might intentionally maintain a dispute with the owner which could cause the owner to refuse to make payment; the general contractor could therefore avail himself for several years of funds to which he has no right." This possibility becomes almost a probability when a general contractor can easily invest such unfairly withheld funds in the money market and receive 15 to 18 percent indefinitely or at least until a subcontractor suit is finally brought to trial.

Generally the states follow the examples of the Federal government on public works construction regulations and contract clauses. In the matter of retainage, however, many of the states have recognized the cash flow problem earlier than some Federal agencies have.

Seven of the states which specify a retainage rate in statutes or published regulations have a rate of four percent or less. Eighteen jurisdictions, including the District of Columbia, have either five percent throughout the project or ten percent on the first 50 percent of the construction with none on the second 50 percent. Five states have a retainage rate over five percent but not over 7½ percent effective at the end of the job, and only two states continue to retain ten percent throughout on all work. Nineteen states have no established retainage rates.

Twenty-seven states have explicit provisions for passing through retainage benefits to subcontractors or for assuring subcontractor payments other than by means of the payment bonds which are universally utilized.

It is possible the surety bond industry will voice objections to the elimination of retainage on Federal construction. Sureties often make claims on retained funds to partially recoup their potential losses. However, this appears to be a self-serving position. Retainage funds were not established for the purpose of protecting surety companies, but rather to protect the building owner from inadequate or incomplete performance and subcontractors, suppliers, and labor from non-payment. The major reason for retainage has been its use to induce completion through the incentive of release of the retained funds upon completion or the punishment of non-release in the event of no completion. As explained earlier, these so-called benefits of retainage are seldom realized.

Performance and payment bonds are a more satisfactory way of accomplishing the objectives and there is no reason to have redundant methods in operation. Surety bonding also helps verify the competency of contractors. Certainly retainage alone will never replace surety bonds as security for all parties, but surety bonds can very adequately replace retainage.

Sureties have the right, the opportunity, and the expertise to consider the financial capabilities, credit, character and experience of their contractor clients before determining whether to write bonds for requested amounts. They know the contractor's backlog and can determine his capability of performing the project for which he is seeking a bond together with other ongoing work.

If sureties perform these functions properly and adequately, they should be able to protect themselves from excessive defaults and claims on bonds. They are adequately rewarded for doing so; surety bonds are expensive for contractors but not nearly as expensive as interest on borrowed working capital. In a way, sureties' demands for continuation of retainage at the ultimate expense of the taxpayers to indemnify them from some of their losses would be similar to contractors asking for government-paid insurance to correct their own mistakes or defective workmanship and to finance their warranty work. Some of the same companies which may seek to write bonds with reduced risks are also in the insurance business. They will not sell insurance to reimburse a contractor for his costs in making good his defective or negligent work. This is regarded by insurers as an avoidable and non-insurable risk, and rightly so to avoid using insurance to pay for poor performance. We do not believe retainage should be required to pay sureties for their poor performance in qualifying clients.

The Impact of Retainage on the Door and Hardware Distributor

A Report of the
Door and Hardware Institute
May 1982

Retainage is a system of uncertain origins, uncertain definition and uncertain application. For the purpose of this report, retainage is the amount held back from payments due a contractor until an owner/developer approves the work under contract. Further, although retainage is imposed in a variety of long-term contract situations, our study is confined to the retainage system as it applies to commercial construction.

It is difficult to pinpoint the origin of retainage but certain observations can be made about the practice. It predates several significant developments in construction law and practice, most notably the adoption of the Uniform Commercial Code, and the development of sophisticated performance or surety-bond requirements. There is also speculation that it was developed in an era when general contractors hired laborers to perform functions that are now handled in a more professional manner by independent subcontractors operating their own businesses. Whatever its origins, its purpose was to provide the owner/developer a measure of protection against inadequate or improper performance by a contractor, while recognizing the need to tender payment for work completed and payment due.

If there is such a thing as "normal practice," an owner/developer imposes a retainage withholding upon the general (or prime) contractor. Ten percent of the payment due is the frequent withholding. It is common, though not universal practice, to reduce that percentage after half the project is completed. (The American Institute of Architects recommends language to that effect.) General contractors, at their own business discretion, impose retainage requirements upon subcontractors and material suppliers. The retainage terms may or may not be identical to those requirements imposed upon the contractor by the developer. General contractors submit a voucher for a draw or progress payment according to a set work-completion schedule.

Included in such a draw are costs attributable to work completed by subcontractors or deliveries made by suppliers during that period. The problems of retainage (and the solutions) fall into two general categories: those which reflect the inherent defects in the retainage system and those which result from the use of an outdated system in a changing construction-law environment. Problems which reflect the defects of the system include delays in release resulting from delays in approval, delays while waiting for others to finish work, misapplication of withholding requirements, failure to pass through releases, and establishment of greater withholding percentages.

DHI

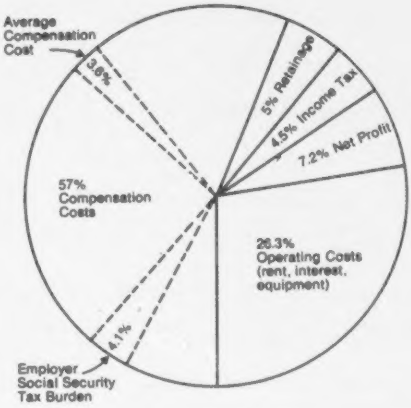
The Door and Hardware Institute is an international association representing nearly 3500 companies and individuals in the total-openings industry. Principal among our membership are distributors and specifiers (Architectural Hardware Consultants) of commercial building hardware, doors and door frames. The principal relationship of members to the construction industry is that of material supplier. While many of the problems of retainage affect material suppliers and subcontractors in similar fashion, there are different problems and solutions for each group. The arguments and facts presented herein are directed specifically to the material supplier's situation; we strongly advise that subcontractors' organizations be contacted for full development of additional issues. One last observation: given the relatively limited involvement of DHI members in the construction process, it should be kept in mind that our estimates of the impact of retainage are likely to be modest compared to the figures of those subcontractors who rely solely on construction.

THE IMPACT OF RETAINAGE ON THE INDUSTRY AND THE DHI DISTRIBUTOR

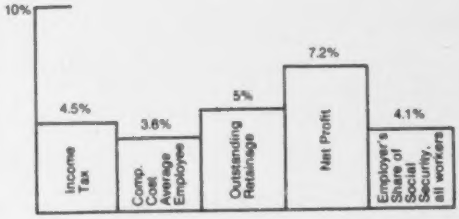
Whatever the abuses and problems of retainage are, the bottom-line effect is the same. Retainage represents a diversion or disruption of cash flow. To weather such a disruption, a small distributor must divert funds from other costs centers such as payroll, taxes or retained earnings. Sometimes the distributor will have to borrow money on a short-term basis to get by. The ironic effect is that the small firm becomes an involuntary banker for others in the construction chain, lending money for months or years at a time. This money is being loaned interest-free despite the fact that, if not for retainage, the money quite properly would be theirs. Though not scientifically devised, a member survey was conducted to determine the effects of retainage on their businesses; this was combined with data regularly collected, so a composite picture could be drawn.

The typical firm in our industry handles net sales of between $1 and 2.5 million annually. The gross margin (net sales minus the cost of goods) is approximately 32%. Of the $1-2.5 million in sales, approximately 85% of the business involves work (contract-hardware or hollow metal sales) which might be involved in retainage situations. Of that 85% only 43% actually involves retainage (36% of net sales). The gross marginal dollar (GMD), net sales minus the cost of goods, of such a firm is divided among these cost centers: 56% is total compensation costs; 3.3% is the average cost per employee; 7.2% is the net profit after taxes (2.3% of net sales); 4.5% is for income taxes; and 4.1% is for employer's share of all employees' social security taxes. The remainder of GMD is divided among other operating costs (administrative, equipment, debt service, rent, utilities). Because of various retainage-release policies and the diversified nature of our business, outstanding retainage carried by a firm equals 1.9% of net sales or 5% of GMD. From these figures you can see that retainage represents the value of 1 1/2 jobs (more accurately, two entry-level jobs). It is equal to two-thirds of net profit (primary source of retained earnings) and is more than the amount paid in corporate income taxes. In graphic terms, retainage sizes up as follows:

Door and Hardware Distributor
$1 to 2.5 million sales
Gross Marginal Dollar*



Gross Marginal Dollar Allocations*



* Gross Marginal Dollar = net sales minus the cost of goods

Of course, the more a firm depends on contract sales, the greater the impact retainage has on the firm. Statistical analysis shows that the gross margin of such firms drops by some 3 percentage points. Assuming a firm does 100% contract sales and 43% of this business requires retainage, then net sales yield a gross margin of 29.5%, as noted above. The figures break down as follows:

Net profit: 9.1% of GMD (2.7% of net sales)

Income taxes: 4.3% of GMD

Average compensation cost of employee: 3.5% of GMD

Retainage: 7.7% of GMD

It becomes obvious that a distributor is faced with several choices: other sales must absorb the losses of retainage, bids must be raised to cover retainage costs, the company must get by with two fewer employees, the owner cannot take anything out of the firm or use retained earnings for expansion, or the owner must borrow to cover retainage.

Several other interesting facts emerged from the survey. The average wait for release of retainage was 143 days and the most frequent response was 180+ days' delay. Many firms replied that a year's delay was not uncommon and at least one firm indicated it carried retainage on the books for five years. One should keep in mind while considering these facts that most of our material suppliers deliver in the second half of the construction schedule. Obviously many subcontractors will experience much longer delays. Some 20% of our members refuse to accept projects involving retainage or do not do work involving retainage. As general policy, most distributors indicate they have an official policy of not accepting work requiring retainage, however economic realities force them to accept retainage work. For most, retainage is a difficult problem to assess and cope with.

FEDERAL CONTRACTS

Retainage can be found in both private- and public-sector construction projects. In procurement matters, civilian agencies are guided by 41 U.S.C. 250 et. seq., and defense agencies follow the law found at 10 U.S.C. 2300 et. seq. Those sections provide the basic framework for government procurement, from solicitation to complete acquisition. Only one section of those laws addresses the subject of payment (41 U.S.C. 255 and 10 U.S.C. 2307). However, neither section provides insight into Congress's view of the need for retainage. The terms of payment therefore are addressed in the two government-wide procurement regulations.

For civilian agencies, the Federal Procurement Regulations(FPR) 41 CFR 1-1 et. seq., establish general guidelines on the subject. For defense agencies, Armed Services Procurement Regulations (ASPR) or Defense Acquistion Regulations (DAR) 10 CFR 1-1 et. seq., accomplish the same (see Appendix A).

In spite of the general guidelines, policy varies from agency to agency and contracting officer to contracting officer. Some agencies have documentable policy; other have informal policies (Appendix B). Although no agency has a retainage policy in excess of 10%, reports indicate a range from strict adherence to 10% withholding, to zero retainage. Further, federal policy addresses only the relationship between the government and the prime contractor.

Over the years, government procurement policy has been the subject of intensive scrutiny. One such attempt to formulate a consistent, uniform policy was undertaken by the U.S. Commission on Government Procurement which reported its findings in a 35- volume study in 1972. The commission's construction study group made the following recommendation for the government's policy on retainage:

> Retained Percentages that FPR and ASPR be amended to permit as normal practice the elimination of retainage on progress payments provided the contract is on schedule. That retention be limited to that required to assure completion of remaining work near the end of construction. As an alternate, that the retained funds be paid the contractor when and if he deposits in escrow eligible securities or bank certificates of deposit (Final Report Study Group #13-C Construction, U.S. Commission Government Procurement, 1972, Volume 31). (Text - Appendix C)

RETAINAGE AS PROTECTION

The rationale for the application of retainage to material suppliers is not readily apparent. In its purest form, the purpose of retainage was to provide the owner/developer with some measure of protection against shoddy performance of labor. It was believed to be difficult to measure the adequacy of labor until there was a completed product. Material supply is subject to an entirely different set of laws. Delivery of goods is tangible, complete and measurable. Goods are available for inspection and most state laws and the Uniform Commercial Code provide for the right of inspection. The Code and state laws also provide for a number of remedies for both improper delivery and defectives goods.

Subcontractors currently are burdened by the duplicative protection of performance bonds and retainage. Both accomplish the same result. Uneven application of retainage withholdings and the uncertainties of work approval result in delays of release. The net effect is to force smaller firms to act as bankers for others, lending money interest-free for months and years at a time. In the best of times, retainage represents a serious disruption to the cash flow of a firm. In difficult economic times it can precipitate a payroll or tax crisis--or even bankruptcy. The solutions are many and varied. In situations where there is no legal foundation for retainage and other legal remedies are available, or where other protection is available, retainage should not apply. If retainage must be withheld, at a minimum funds should be placed in interest-bearing escrow, and release should be on a "line-item basis" to insure that subcontractors or suppliers are not forced to wait for others to finish work. In some cases direct payment from the owner/developer to the subcontractor/material supplier may be the ultimate solution.

CONCLUSION

Retainage is an antiquated system of protection which has outlived its effectiveness. Rather than provide protection it has added to the costs of construction and contributed to delays. For material suppliers the logic of the system would not appear to apply. Although the hardware and door segment is relatively small in comparison to the remainder of the industry, rough estimates indicate at any given time it is carrying $10-17 million in retainage. The costs of borrowing to cover retainage may be as high as $2-3 million a year. Finally, it may be costing as many as 700-800 new entry-level jobs in distributor firms.

APPENDIX A

PAYMENTS TO CONTRACTOR (1979 Mar) (41 CFR 1-7.602-7)

(a) The government will pay the contract price as hereinafter provided.

(b) The government will make progress payments monthly as the work proceeds, or at more frequent intervals as determined by the Contracting Officer, on estimates approved by the Contracting Officer. If requested by the Contracting Officer, the contractor shall furnish a breakdown of the local contract price showing the amount included therein for each principal category of the work, in such detail as requested to provide a basis for determining progress payments. In the preparation of estimates the Contracting Officer, at his discretion, may authorize material delivered on the site and preparatory work done to be taken into consideration. Material delivered to the Contractor at locations other than the site may also be taken into consideration (1) if such consideration is specifically authorized by the contract and (2) if the Contractor furnishes satisfactory evidence that he has acquired title to such material and that it will be utilized on the work covered by this contract.

(c) In making such progress payments, there shall be retained 10 percent (10%) of the estimated amount until final completion and acceptance of the contract work. However, if the Contracting Officer finds that satisfactory progress was achieved during any period for which a progress payment is to be made, he may authorize such payment to be made in full without retainage of a percentage. Also, whenever the work is substantially complete, the Contracting Officer shall retain an amount he considers adequate for the protection of the Government and, at his discretion, may release to the Contractor all or a portion of any excess amount. Furthermore, on completion and acceptance of each separate building, public work, or other division of the contract, on which the price is stated separately in the contract, payment may be made therefore without retention of a percentage.

(d) All material and work covered by progress payments made shall thereupon become the sole property of the Government, but this provision shall not be construed as relieving the Contractor from the sole responsibility for all material and work upon which payments have been made or the restoration of any damage work, or as waiving the right of the Government to require the fulfillment of all of the terms of the contract.

(e) The Contractor shall, upon request, be reimbursed for the entire amount of premiums paid for performance and payment bonds (including coinsurance and reinsurance agreements, when applicable) after furnishing evidence of full payment to the surety.

(f) Upon completion and acceptance of all work, the amount due the Contractor under this contract shall be payed upon the presentation of a properly executed voucher and after the Contractor shall have furnished the Government with a release of all claims against the Government arising by virtue of this contract, other than claims in stated amounts as may be specifically excepted by the Contractor from the operation of the release. If the Contractor's claim to amounts payable under the contract has been assigned under the Assignment of Claims Act of 1940, as amended (31 U.S.C. 203, 41 U.S.C. 15), a release may also be required of the assignee.

PAYMENTS TO CONTRACTOR (10 CFR 1-7.602-7)

(a) The Government will pay the contract price as hereinafter provided.

(b) The Government will make progress payments monthly as the work proceeds, or at more frequent intervals as determined by the Contracting Officer, on estimates approved by the Contracting Officer. If requested by the Contracting Officer, the Contractor shall furnish a breakdown of the total contract price showing the amount included therein for each principal category of the work, in such detail as requested, to provide a basis for determining progress payments. In the preparation of estimates the Contracting Officer, at his discretion, may authorize material delivered on the site and preparatory work done to be taken into consideration. Material delivered to the Contractor at locations other than the site may also be taken into consideration (1) if such consideration is specifically authorized by the contract and (2) if the Contractor furnishes satisfactory evidence that he has acquired title to such material and that it will be utilized on the work covered by this contract.

(c) In making such progress payments, there shall be retained 10 percent of the estimated amount until final completion and acceptance of the contract work. However, if the Contracting Officer finds that satisfactory progress was achieved during any period for which a progress payment is to be made, he may authorize such payment to be made in full without retention of a percentage. Also, whenever the work is substantially complete, the Contracting Officer shall retain an amount he considers adequate for protection of the Government and at his descretion, may release to the Contractor all or a portion of any excess amount. Furthermore, on completion and acceptance of each separate building, public work, or other division of the contract, on which the price is stated separately in the contract, payment may be made therefore without retention of a percentage.

(d) All material and work covered by progress payments made shall thereupon become the sole property of the Government, but this provision shall not be constructed as relieving the Contractor from the sole responsibility for all material and work upon which payments have been made or the restoration of any damaged work, or as waiving the right of the Government to require the fulfillment of all of the terms of the contract.

(e) If Miller Act (40 U.S.C. 270a-270e) performance of payment bonds are required under this contract, the Government shall pay to the Contractor the total premiums paid by the contractor to obtain the bonds. This payment shall be paid at one time to the contractor together with the first progress payment otherwise due after the contractor has (1) furnished the bonds (including coinsurance and reinsurance agreements, when applicable), and (2) furnished evidence of full payment to the surety company, and (3) submitted a request for such payment. The payment by the Government of the bond premiums to the contractor shall not be made as increments of the individual progress payments and shall not be in addition to the contract price.

(f) Upon completion and acceptance of all work, the amount due the Contractor under this contract shall be paid upon the presentation of a properly executed voucher and after the Contractor has furnished the Government with a release of all claims against the Government, arising by virtue of this contract, other than claims in stated amounts as may be specifically excepted by the Contractor from the operation of the release. If the Contractor's claim to amounts payable under the contract has been assigned under the Assignment of Claims Act of 1940, as amended (31 U.S.C. 203, 41 U.S.C. 15), a release may also be required of the assignee.

APPENDIX B

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301

MANPOWER,
RESERVE AFFAIRS
AND LOGISTICS

8 FEB 1982

MAR 4 1982

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE ARMY (IL&FM)
ASSISTANT SECRETARY OF THE NAVY (S&L)
ASSISTANT SECRETARY OF THE AIR FORCE (MRA&I)

SUBJECT: Department of Defense Policy on Retainage

Interest on commercial construction loans remains high and we must expect that the carrying cost on retained payment will be included in contract bids. Current construction contract retainage practices are likely to add costs to our construction program, therefore, and do not necessarily improve the quality or utility of the project. By controlling retainage on our contracts, we should realize economic savings in Department of Defense construction. The objective of this policy statement is to reduce our construction program costs and still permit Construction Agents to manage their contract effort in a businesslike manner.

As a matter of Department of Defense policy, retainage will not be routinely used throughout the term of contracts for construction projects which are on or ahead of schedule and otherwise substantially in compliance with contract requirements. Some level of retainage may be used as the contract approaches completion, however, to ensure that construction deficiencies are corrected promptly and that completion is timely. Further, in specific cases, where past unsatisfactory performance by a certain contractor has been experienced or there is another valid consideration relating to a particular contract, the Construction Agent may elect to withhold retainage throughout the term of the contract if that will be in the best interest of the government. Construction Agents are to exercise these options with discretion and for specific justification. Retainage will no longer be a routine administrative practice.

This policy on retainage must be complemented by prompt and positive final payment procedure after a contractor has completed all contract requirements. This should improve our perception as a preferred customer by the construction industry and tend to reduce our contract construction costs even more.

Robert A. Stone

Robert A. Stone
Deputy Assistant Secretary of Defense
(Facilities, Environment, and Economic Adjustment)

APPENDIX C

Text of U.S. Commission on Government Procurement Final Report on subject of Retainage

The Retained Percentage - It is common practice for Federal agencies (and non-Federal Governmental agencies) to withhold 10 percent of progress payments until the contract is 50 percent complete. On a contract of $10 million the Government will withhold $500,000 which serves to increase the contractor's borrowings by a like amount and these costs are now being included in the bid prices. The GAO estimates Federally financed construction contracts for 1970 at about $30 billion; thus, at 9 percent interest the retained percentage could be costing the Government construction procurement more than $30,700,000 per year or approximately $84,000 per calendar day. The following table shows the estimated savings:

ITEM		ANNUAL FIGURES
GAO Estimate of Construction Contracts involving Federal Funds		$30,000,000,000
Monthly OUtlay of Above		$ 2,500,000,000
Average Retention	7.5%	
Monthly Retention		$ 115,000,000
Interest Rate to Contractors	9 %	
Cost of Capital to Contractors (Assumes Uniform series with LS Payment at end of year)		$ 79,000,000
(A) This is what is passed on to taxpayer		$ 79,000,000
(B) If retention eliminated, cost of additional Government borrowing estimated at 5 1/2%		$ 43,300,000
(A-B) Net cost to taxpayer of current retention system		$ 30,700,000 PER YEAR

POTENTIAL FEDERAL SAVINGS:

Direct Construction		5.1 million per year
Grant Construction		7.6 million per year
	TOTAL	12.7 million per year

Federal agencies defend the custom as being necessary to insure that the contractor will complete his contract in an expeditious manner; however, most administrators agree that retention is really only needed if contractor is falling behind schedule or at the end of the construction period as his incentive to finish the work.

The surety industry has major objection to reducing the current requirements as to retained percentage. They point out that a substantial "retainer" is occasionally the only factor that persuades a contractor to stay on the job. The sureties readily admit that the bonding company is the principal beneficiary if the retained percentage were reduced from the now 5 percent maximum to 1 percent maximum would be offset by either increase in bond premiums or increase difficulty in administering construction contracts or both.

One solution that both the contractors and sureties agree on is the substitution of contractor-owned approved securities for the retained percentage. The Interior Department is now permitting this on some construction contracts as are the States of Arkansas, California, Connecticut, Maine, Montana, New Hampshire, New York, North Dakota, Oklahoma, Pennsylvania, Rhode Island, Utah, West Virginia, Wyoming, Washington, and Tennessee.

One Federal agency objected to the proposal on the basis that "this is not practical because the U.S. Treasury would have to borrow additional money to cover the increase deficit." This assumption that somehow the contractor should participate in financing the project is difficult to understand, especially when the Government usually borrows at less than the prime bank rate while the contractor usually pays an effective interest rate considerably above the prime rate. However, if the concept is accepted the estimated savings would be substantially less.

If certificates of deposits are accepted, the cost to the contractor would be reduced from $79,000,000 to $30,700,000 or a savings in contractor financing of 48.3 million per year. This assumes the same 9% interest rate and a bank interest rate of 5.5% paid on the certificates of deposit. Under competitive bidding system this savings would be passed on to the taxpayer in lower bid prices (pgs. 70-73).

Recommendation: that FPR and ASPR be amended to permit as normal practice the elimination of retainage on progress payments provided the contract is on schedule. That retention be limited to that required to assure completion of remaining work near the end of construction. As an alternate, that retained funds be paid the contractor when and if he deposits in escrow eligible securities or bank certificates of deposit (p. 31).

APPENDIX D

Text of

H.R. 5022 and S. 1782

To amend section 305 of the Federal Property and Administrative Services Act of 1949 pertaining to contract progress payments made by agencies of the Federal Government, to provide for the elimination of retainage in certain instances, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION I. This Act may be cited as the "Small Business Contract Payment Procedures Act."

Section II. Section 305 of the Federal Property and Administrative Service Act of 1949 (41 U.S.C. 255) is amended by adding at the end thereof the following:

(d) Whenever an executive agency makes progress payments under the authority of subsection (a)(1)

(1) such progress payments shall be made monthly as the work proceeds, at more frequent intervals as determined by the contracting officer, or at intervals stipulated by the contract;

(2) if the contracting officer finds that satisfactory progress toward completion of performance of the contract was achieved during any period for which a progress payment is to be made he shall authorize such payment to be made in full without retention of any percentage of the contract price; and

(3) if the party performing the contract is a small business concern, as defined in section 3 of the Small Business Act, which has furnished an adequate performance bond, as determined by the contracting officer, he shall authorize such payment to be made in full without retention of any percentage of the contract price."

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